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IN THE

Supreme Court of the United States

October Term, 1985

SAN DIEGO GAS & ELECTRIC COMPANY,

Appellant,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF CALIFORNIA

APPENDIX TO THE JURISDICTIONAL STATEMENT OF APPELLANT SAN DIEGO GAS & ELECTRIC COMPANY

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APP

TABLE OF CONTENTS

		Page
A.	Decision No. 84-02-005	A-1
B.	Decision No. 84-12-026	A-27
C.	Decision No. 85-04-111	A-67
D.	Order Denying Writ Of Review	A-74
E.	Notice of Appeal to the Supreme Court of the United States	A-75
F.	List of Proceedings Involving Prudence Reviews Pending Before California Public Utilities Commission	A-78

Public Utilities Commission
State of California

Decision 84-02-005

February 1, 1984

TO: ALL PARTIES OF RECORD IN A.83-07-16

The Administrative Law Judge's proposed decision was signed without change by the Commission and accordingly, a separate document will not be filed and served under AB 2570 in order to save the expense of reproduction and postage.

Mary Carlos
Chief Administrative Law Judge

MC:bg

Decision 84-02-005 February 1, 1984

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application for SAN DIEGO GAS & ELECTRIC COMPANY, for Authority to revise its Energy Cost Adjustment Clause Rate, to revise its Annual Energy Rate, and to revise its Electric Base Rates in Accordance with the Electrical Revenue Adjustment Mechanism established by Decision 93892.	Application 83-07-16 (Filed July 8, 1983)

Barton M. Myerson, Randall W. Childress, William L. Reed, and Jeffrey L. Guttero, Attorneys at Law, for San Diego Gas & Electric Company, applicant.

John W. Witt, City Attorney, by William J. Shaffran and *Steven A. McKinley*, Deputy City Attorneys, for the City of San Diego; *F. E. John* and T. D. Clarke, by Gay M. Phillips, Attorneys at Law, for Southern California Gas Company; *Allen R. Crown*, Attorney at Law, for California Farm Bureau Federation; and *Harry K. Winters*, for University of California; interested parties.

Richard Rosenberg, Attorney at Law, for the Commission staff.

INTERIM OPINION

I. Summary of Decision

In this interim opinion, we adjust San Diego Gas & Electric's (SDG&E) Energy Cost Adjustment Clause (ECAC) rate, Annual Energy Rate (AER), and Electric Revenue Adjustment Mechanism

(ERAM) rate. The calculated adjustments would produce a net reduction of revenue of $65.5 million. However, in Decision (D.) 83-11-091 issued November 22, 1983, we already have ordered SDG&E to lower its ECAC rate to reduce revenues by $38.9 million. That reduction was ordered to offset a rate increase allowed for SONGS Unit 2. Accordingly, at this time we pass through to the ratepayer only the remaining $26.6 million.

We find SDG&E to have been unreasonable in entering into the 1979 Restated Agreement with Tesoro. An appropriate disallowance will be determined after further hearings.

II. Introduction

Application (A.) 83-07-16 is SDG&E's ECAC and AER forecast for the period beginning November 1, 1983.

After SDG&E filed the application, the Commission issued D.83-08-048 in Order Instituting Investigation (OII) 82-04-02, which established a new 92% ECAC/8% AER split for SDG&E and ordered proportional inclusion of all energy costs in both the ECAC rate and the AER. The decision also set the interest rate for Bankers' Acceptances as SDG&E's carrying cost on oil in inventory.

On September 7, 1983, the Commission issued D.83-09-007 in A.82-02-40 and A.82-03-63, which adjusted SDG&E's ECAC rate and AER to reflect the ratemaking treatment of San Onofre Nuclear Generating Station (SONGS) Unit 2.

SDG&E modified its showing to reflect the effects of both D.83-08-048 and D.83-09-007.

A prehearing conference was held on August 15, 1983. Twenty-four days of evidentiary hearing were held from August 25, 1983 to November 28, 1983. SDG&E presented eleven witnesses, and staff presented five.

Opening briefs were due December 16, 1983 and reply briefs on December 23, 1983. Staff requested a one week extension of time which was granted. SDG&E and the City of San Diego (City) timely filed opening briefs on December 23, 1983. Staff filed its opening brief on the Tesoro Suspension Agreement on December 27, 1983. Staff filed a supplementary brief covering the forecast issues on January 3, 1984. SDG&E filed a reply brief on January 5, 1984.

III. Issues

The issues raised by A.83-07-16 are important and varied. The usual forecast issues, i.e., prediction of SDG&E's energy costs, for the period November 1, 1983 to October 31, 1984 must be addressed. This annual endeavor to estimate test year oil, gas, purchased power, nuclear, and other energy costs overshadows the biennial general rate proceedings since SDG&E's energy costs are most of the utility's total operating costs. In addition, the increase of the AER from 2% to 8% of SDG&E's energy costs quadrupled the amount of energy expense that is recovered through a base rate based on test year estimates. Consequently, the estimates of SDG&E's energy costs to be adopted in our forecast are more important than before.

A.83-07-16 also includes a reasonableness review of the period July 1, 1982 to April 30, 1983. SDG&E is required to come forward with percipient witnesses and show that the management of its energy expense in the review period was "prudent and reasonable." While the staff generally identifies several reasonableness issues, intervenors frequently develop and pursue their own issues through the hearing and briefing process. Thus, all of the reasonableness issues often are not well-defined until the proceeding has been submitted.

The Commission also held over from the prior reasonableness review proceeding for SDG&E, A.82-08-014, the matter of the Tesoro Suspension Agreement. Extensive hearings were held in

A.82-08-014 in which SD&GE [*sic*], staff, and Tesoro-Alaskan Petroleum Corporation (Tesoro) presented witnesses on the Tesoro Suspension Agreement. However, the Commission deferred a decision to this proceeding and directed the staff to investigate further the circumstances surrounding the negotiation of the Suspension Agreement so the Commission would know more about the negotiation process before ruling on the agreement.

During hearing on the present application, the City argued that not only the Suspension Agreement entered into in 1982 but also the underlying 1979 Restated Agreement between Tesoro and SDG&E was at issue. The City pointed out that prior Commission decisions expressly held the 1979 record period open for review by the staff or intervenors. (See D.91106, 2 CPUC 2d 572, 576-577, issued December 19, 1979 and D.91545, 3 CPUC 2d 503, issued April 15, 1980.) The City then requested that SDG&E provide a witness on the 1979 Restated Agreement. The presiding administrative law judge (ALJ) ruled in favor of the City and ordered SDG&E to present a witness and further testimony on the 1979 Restated Agreement. SDG&E filed a motion to overturn the ALJ's ruling but provided a witness under protest. We affirm the ALJ's ruling and consider the 1979 Restated Agreement to be within the scope of this reasonableness review as clearly stated in our prior decisions. Furthermore, we consider any discretionary action by utility management which directly affects energy expenses incurred in the record period to be within the scope of our reasonableness review even if the action was taken before the record period. SDG&E's motion to overturn the ALJ's ruling is denied.

In summary, the areas at issue in A.83-07-16 consist of (1) the appropriate forecast for the November 1, 1983 to October 31, 1984 period (forecast period), (2) the reasonableness review of the July 1, 1982 to April 30, 1983 period (record period), (3) the Tesoro Suspension Agreement, and (4) the 1979 Restated Agreement between SDG&E and Tesoro.

Despite the extended hearing schedule, evidence and testimony on the record period was not received. So, further hearings will be held for this Area (2). In this Interim Opinion, we will address the forecast issues and decide the reasonableness of the Tesoro Suspension Agreement as well as the 1979 Restated Agreement.

IV. ECAC/AER Forecast

As discussed earlier, SDG&E's forecast showing was adjusted several times throughout the proceeding to account for the effects of Commission decisions issued after the application was filed. The last update was received as Exhibit 43, which shows a net revenue reduction of $57.3 million. This estimated reduction is based upon an ECAC rate decrease of .311¢/kWh, an AER increase of .181¢/kWh, and an Electric Revenue Adjustment Mechanism (ERAM) rate decrease of .426¢/kWh.

The centerpiece of SDG&E's forecast presentation is Exhibit 4 which explains the forecast resource mix. The resource mix was developed in the following manner:

1. SDG&E's Economic Research & Forecasting Department devloped an *electric sales estimate* for the forecast period using an econometric model which estimates average use by customer type and customer additions by quarter. From this sales estimate, SDG&E derived a system energy requirement of 12,140 Gigawatthours (GWHR).

2. SDG&E's Electric Operations Department developed a *purchased energy estimate* based on historical trends and existing contracts with other utilities. (Also, see Exhibit 22.)

3. SDG&E's Nuclear Department developed an estimate of *SONGS generation* with the operator, Southern California Edison (SCE).

4. The above data then was entered into SDG&E's *production costing program* which accounts for unit heat rates, capacity factors, forced outages, spinning reserve requirements, planned maintenance, and resource additions in determining SDG&E's fossil generation requirements. This program is a computer simulation of SDG&E's system.

5. The *maximum* amount of *gas* available to *burn* is derived from the production costing program's prediction of fossil generation requirements.

6. SDG&E's Gas Planning Department then provides its prediction of the *level of service* SDG&E should expect from its supplier, the Southern California Gas Company (SoCal).

7. Next, any fossil generation requirements which cannot be met by burning gas are assumed to be met by *low sulfur residual oil* (*LSFO*) *burn unless* additional oil burn is required for inventory control.

8. SDG&E calculated its required *LSFO inventory* level using three methodologies and selected an average inventory level for the forecast period.

9. SDG&E considered the level of LSFO deliveries under its Hawaiian Independent Refinery Incorporated (*HIRI*) *contract* in the forecast period, determined that contract deliveries exceeded its LSFO requirements by 1-1.3 million barrels, and evaluated the most economic disposal method, i.e., burn, store, sell, underlift, etc. SDG&E decided that the projected excess should be burned.

10. Finally, SDG&E derived a *resource mix* with its production cost program *after* including the effect of the

LSFO inventory control burn which the program otherwise would not have projected. The resulting resource mix which includes SONGS Unit 2 generation is as follows:

Resource	GWHR	% of Total Mix
Purchased Energy	5,074.2	41.79
Nuclear Generation	1,335.3	11.00
Natural Gas	3,813.3	31.41
Diesel Oil	0.2	0.00
LSFO	1,918.7	15.80
Total	12,141.7	100.00

SDG&E did not include SONGS Unit 3 generation in the forecast resource mix as nuclear generation because the impact of that facility's commercial operation on the ECAC rate and the AER in the forecast period will be examined in the rate base offset proceedings. (Natural gas is used as the "avoided cost" proxy for the expected SONGS Unit 3 generation in the above resource mix.)

SDG&E's forecast process was examined throughout the hearing, sometimes in minute detail. SDG&E was required to supplement its original showing with additional testimony on its purchased power estimate, SONGS Unit 2 projected capacity factor, and HIRI contract obligations. The staff and the City were given ample opportunity to cross-examine SDG&E's witnesses, to conduct further discovery, and if desired to present additional witnesses. This time-consuming procedure was permitted in recognition of the increased importance of the forecast underlying the AER.

Only a few issues related to SDG&E's forecast emerged in the briefs submitted by the parties. First, SDG&E and staff disagree on the appropriate level of LSFO inventory. Second, SDG&E and staff differ on the predicted capacity factor for SONGS Unit 2. Last, staff contends that the HIRI contract and the related Chevron transportation agreement will impose excessive and unwarranted costs on the ratepayer; however, staff does not make a

specific proposal of disallowance or other Commission action. These differences when combined amount to a total difference of only $2.206 million or .4%. The AER portion of this difference is only $176,477. (Exhibit 47, p. 1.) We conclude that the parties essentially now agree that SDG&E's forecast resource mix is reasonable. Accordingly, we substantially adopt SDG&E's forecast resource mix.

Despite our adoption of SDG&E's forecast, we must emphasize that SDG&E's management of 92% of its energy costs in the forecast period will be subject to reasonableness review in a forthcoming proceeding. The purpose of the forecast and the derived AER is to predict as best we can what SDG&E's energy costs will be at this single point in time and to set a base rate for 8% of these costs in the AER. SDG&E will retain the difference between the AER revenue and 8% of its actual energy costs within its earnings cap limitation of ± 120 basis points. SDG&E should have some incentive to lower costs because the larger AER is in effect.

In choosing a forecast now, we are not in any way endorsing SDG&E's "plan of action" for the forecast period. Rather, we are troubled by several aspects of SDG&E's Fuel Management Plan as presented in its testimony. We will comment on several of our concerns now to alert SDG&E and the other parties that we intend to closely examine SDG&E's fuel management decisions in the next reasonableness review proceeding.

First, we are concerned with the constraints that the HIRI contract has placed on SDG&E. The contract forces SDG&E to burn volumes of LSFO beyond the volumes called for under Efficiency Dispatch of the utility's generation system. The contract also prevents SDG&E from switching to Incremental Cost Dispatch which is SDG&E's lowest cost dispatch method. Moreover, we are aware that HIRI is willing to negotiate an underlift of the contract volumes. Limited negotiations between SDG&E and HIRI have already occurred. Thus, SDG&E has an opportunity to reduce its

LSFO burn. Despite the foregoing, SDG&E insists that an underlift will not occur in the forecast period.

We question SDG&E's continuing belief that a long-term LSFO supply is the only "reasonable course of action." The alleged benefits of SDG&E's long-term LSFO contracts have failed to materialize while the cost of these agreements has been instrumental in SDG&E charging one of the three highest electric retail prices in the country. We expect SDG&E to aggressively pursue all available options in solving its LSFO oversupply problem as well as the associated Chevron transportation charges. We repeat that SDG&E's management in this area will be scrutinized and questioned.

Second, we remain concerned about SDG&E's calculation of an appropriate LSFO inventory. SDG&E's analysis again relies upon a worst case scenario. The analysis is based only upon the utility's ability to replenish its LSFO inventory in an emergency situation. No consideration was given by SDG&E to other resource options such as purchased power. While SDG&E maintains that the oil-order option is not the only option SDG&E management could choose, it is the only option SDG&E considered in determining its minimum winter and summer LSFO inventories. Furthermore, as pointed out by staff witness Danner, SDG&E's analysis does not attempt to arrange the schedule of oil deliveries to coincide with the required oil burn. Focusing only upon this single scheduling factor, Danner was able to derive an average LSFO inventory 400,000 barrels lower than SDG&E's. This limited study by Danner shows that affirmative action by SDG&E management can substantially reduce the level of SDG&E's LSFO inventory. We choose to adopt Danner's inventory level of 1,006,000 barrels because we are convinced that SDG&E's analysis does not adequately consider affirmative management action in an emergency situation.

Finally, we choose to adopt staff's capacity factor for SONGS Unit 2. The staff has used the same capacity factor that was used

to adjust SCE's ECAC rate and AER. We see no reason why a different number should be used for SDG&E.

In summary, we adopt SDG&E's entire forecast, apart from its requested LSFO inventory level and SONGS Unit 2 capacity factor. The ECAC rate decrease of .385¢/kWh and AER increase of .174¢/kWh are shown in Table 1. These rate adjustments combined with an ERAM rate decrease of .426¢/kWh amount to a net reduction of revenue of about $65.5 million as compared to SDG&E's request of $57.3 million. The difference of $8.2 million is due to our adoption of a lower LSFO inventory level ($1.4 million), SONGS Unit 2 capacity factor (.8 million), and the removal of Tesoro underlift payments ($6 million) from the total expenses. Recovery of the Tesoro underlift payments will be addressed in the next section of this decision.

Consistent with our recent decision in SDG&E's general rate case (D.83-12-065) the System Average Percentage Change Method will be used to allocate the revenue changes flowing from this decision among customer classes.

Table 1

ECAC-AER Derivation

	M$
Purchased Energy	200,527.0
Nuclear Generation	18,090.0
Natural Gas	217.269.3 [*sic*]
Diesel Oil	34.0
LSFO	114,680.0
Subtotal Fuel and Purchased Energy	550,600.3
Plus New Albion Resources	1,610.3
Plus Variable Wheeling Expenses	2,059.3
Underlift Payments (Chevron Transp.)	928.185
Carrying Cost of Oil In Inventory	4,175.98
Total Expenses	559,374.165
ECAC - 92%	514,624.195
AER - 8%	44,749.970
ECAC offset rate decrease	.320¢/kWh
ECAC balancing rate decrease	.065¢/kWh
ECAC rate decrease	.385¢/kWh
AER increase	.174¢/kWh
Adopted AER	.429¢/kWh

V. 1979 Restated Agreement

SDG&E entered into the original agreement with Tesoro in July, 1974. The original agreement provided SDG&E with maximum LSFO deliveries of 10,000 barrels/day (bbl/d) from 1975 to 1980 and 5,000 bbl/d in 1981. This agreement was executed after the Commission encouraged the electric utilities to enter into long-term contracts with LSFO suppliers. (D.81931 issued September 25, 1973, 75 CPUC 713.)

The original agreement was amended on February 5, 1976 (Amendment No. 1) and on January 16, 1978 (Amendment No. 3). After Amendment No. 3 took effect, the maximum contract volumes had doubled to 20,000 bbl/d from 1978 to 1980 and to 10,000 bbl/day in 1981.

On January 1, 1979, the Restated Agreement took effect. Under the Restated Agreement, SDG&E was obligated to receive 17,000 bbl/d in 1979 and 1980, 18,000 bbl/d in 1981, 16,000 bbl/d in 1982, and 7,000 bbl/d in 1983. The Restated Agreement lowered contract deliveries in 1979 and 1980 by 3,000 bbl/d but increased contract deliveries by 8,000 bbl/d in 1981, 16,000 bbl/d in 1982, and 7,000 bbl/d in 1983. This renegotiation increased SDG&E's total contract deliveries from Tesoro by 9,125,000 barrels.

SDG&E maintains that the Restated Agreement seemed reasonable in late 1978. At that time, SDG&E's oil inventories had reached maximum operating levels due to the unexpected availability of natural gas and purchased energy. In addition, the disposal cost of LSFO in the spot market exceeded the economic benefit of burning natural gas. Accordingly, SDG&E tried to negotiate a reduction of contract volumes with Tesoro so that the utility could burn available natural gas.

Tesoro was unwilling to negotiate any volume reductions unless SDG&E would agree to a long-term extension of the contract. SDG&E tried to evaluate the benefits of a short-term reduction in

LSFO deliveries against the risks of a contract extension beyond 1981.

SDG&E asserts that during this period the long-term outlook for natural gas as a powerplant fuel was very pessimistic. For example, the 1977-1980 California Gas Reports showed levels of service to P-5 customers to be below 20% in 1982-1983. SDG&E believed that little or no powerplant gas would be available in the early 1980's.

Because of these pessimistic gas availability forecasts, SDG&E's projections of long-term LSFO requirements were increased. These projections were revised in November, 1978 to perform an analysis of the contract changes being negotiated with Tesoro. The revised projections showed that SDG&E's LSFO requirements had a 75% probability of not exceeding 13.5 million barrels in 1979, 13.7 million barrels in 1980, 13.9 million barrels in 1981, 11.2 million barrels in 1982, and 9.9 million barrels in 1983. SDG&E claims the above forecasted requirements exceeded the contractual commitments the utility was considering at that time.

In the utility's view, the Restated Agreement enabled SDG&E to reduce its LSFO volumes in the short-term and to accept more natural gas as it became available in 1979 and 1980. In return for this short-term benefit, SDG&E exposed itself to what was then perceived as "a relatively insignificant possibility that LSFO supply would exceed requirements in 1982 and 1983."

In addition, SDG&E points out that HIRI, the utility's other supplier, had at times declared the possibility of a force majeure reduction of contract volumes. SDG&E asserts that the Restated Agreement gave SDG&E in Tesoro, a LSFO supplier dependent on domestic sources of crude in addition to HIRI, a supplier dependent on foreign sources.

SDG&E's fuel procurement strategy at that time was to depend on the sport market for no more than 5-10% of LSFO require-

ments. Thus, using the utility's November, 1978 revised projections of LSFO requirements, SDG&E's strategy called for a firm contract supply of 12.2-12.8 million barrels in 1979, 12.3-13.0 million barrels in 1980, 12.5-13.2 million barrels in 1981, 10.1-10.6 million barrels in 1982, and 8.9-9.4 million barrels in 1983. The balance of the forecast requirements could be obtained on the spot market or from other resources.

Under the Restated Agreement, SDG&E agreed to receive from Tesoro about 6.2 million barrels of LSFO in 1979 and 1980, 6.6 million barrels in 1981, 5.8 million barrels in 1982, and 2.6 million barrels in 1983.

SDG&E's witness Watkins testified that SDG&E's contract with HIRI provided 14,000 bbl/d through 1984. This is equivalent to 5.1 million barrels per year. A tabulation of these contract volumes shows that SDG&E's firm contract volumes with the Restated Agreement exceed 90-95% of its forecast LSFO requirements only in 1982.

Year	90-95% of Forecast LSFO Requirements	Restated Tesoro Volumes	HIRI Volumes
	(millions of barrels)		
1979	12.2-12.8	6.2	5.1
1980	12.3-13.0	6.2	5.1
1981	12.5-13.2	6.6	5.1
1982	10.1-10.6	5.8	5.1
1983	8.9- 9.4	2.6	5.1

However, Watkins neglected to mention that at the time negotiations with Tesoro were occurring, the HIRI contract volumes could have been increased at the utility's option from 14,000 bbl/d to 28,800 bbl/d upon two years' written notification. (Amendment No. 7 dated May 10, 1978.) Therefore, SDG&E could have relied upon a range of 5.1-10.5 million barrels from HIRI in 1981-1983. However, instead of relying upon the HIRI option, SDG&E chose to extend the Tesoro agreement from 1981 to 1983.

Another tabulation of SDG&E's contract volumes before the Restated Agreement shows that firm contract volumes did not exceed 90-95% of forecast LSFO requirements from 1979 to 1983.

Year	90-95% Forecast LSFO Requirements	Tesoro Volumes Before Restated Agreement	HIRI Volumes w/ Option to Increase Deliveries
	(millions of barrels)		
1979	12.2-12.8	7.3	5.1
1980	12.3-13.0	7.3	5.1
1981	12.5-13.2	3.65	5.1-10.5
1982	10.1-10.6	-	5.1-10.5
1983	8.9- 9.4	-	5.1-10.5

After comparing these tabulations, we conclude that although SDG&E was able to reduce contract volumes in 1979 and 1980 by entering into the Restated Agreement with Tesoro, these short-term reductions were more than offset by the increased volume obligations in 1981-1983. SDG&E paid a heavy price since it in effect substituted a flexible option to call upon HIRI to deliver increased volumes for the extension of an inflexible take-or-pay agreement with Tesoro. SDG&E would pay very dearly for this substitution. From these facts alone, we conclude that SDG&E's decision to enter into the Restated Agreement reflects extremely poor management judgment.

What benefits did SDG&E expect to receive under the Restated Agreement? SDG&E estimated at the time that just *$500,000* in fuel savings would result from the volume reductions in 1979 and 1980. This projected benefit does not equal the risk of excess LSFO in 1981-1983 that SDG&E assumed under the Restated Agreement.

SDG&E's own economic analysis of the Restated Agreement's benefits demonstrates that the modest fuel savings were not worth extension of the agreement. Watkins testified that in approving the Restated Agreement he had specifically relied upon Enclosure 1 of the utility's economic analysis. Enclosure 1 showed the probability that SDG&E would have excess LSFO under the Restated Agreement

in the years 1979-1983. After reviewing Enclosure 1, Watkins said the Restated Agreement reduced the risk of excess LSFO in 1979 by about 50% since the graph indicated an approximate 80% probability of excess LSFO without the Restated Agreement and only a 30% probability of excess LSFO with the Restated Agreement. Upon closer examination, the probability difference is about 40% rather than 50%. Nonetheless, we agree that the Restated Agreement substantially reduced the risk of excess LSFO in 1979 according to Enclosure 1. A similar analysis for 1980 shows that the Restated Agreement reduced the probability of excess LSFO in that year by about 10%. However, Enclosure 1 also shows that extension of the Tesoro Agreement through 1983 had the effect of *increasing* the probability of excess LSFO in 1981 by 15% and in 1982 by 35%. Thus, SDG&E's own probabilistic analysis in Enclosure 1 showed at best marginal benefits from the Restated Agreement. Clearly, Watkins and the rest of SDG&E's management were concerned only about a short-term solution to the LSFO oversupply problem. Inadequate consideration was given to the added risk of excess LSFO in later years that the Restated Agreement created.

Why did SDG&E enter into the Restated Agreement? We conclude after a careful review of the evidence and testimony that SDG&E was trying to avoid Commission assessment of a $1/bbl penalty for the rejection of available gas in 1979 and 1980. The memoranda attached as Appendix D to Exhibit 44 have several references to the possibility of a $1/bbl penalty.

> "In order to make the ratepayer indifferent as to whether fuel oil would be burned in preference to cheaper natural gas, a $1/bbl penalty *could* be levied by the CPUC for every barrel equivalent of gas rejected."

> "In order to make the ratepayer indifferent as to whether oil would be burned in preference to cheaper natural gas, a $1 penalty could be levied by

> the CPUC for every BBLR of natural gas rejected. A fifty-fifty chance of such a penalty was assumed." (Exhibit 44, App. D, pp. 1, 6.)

SDG&E apparently was preoccupied with the possibility of a Commission disallowance for rejected natural gas in 1979 and 1980 and entered into the Restated Agreement without adequate consideration of the possibility of excess LSFO in later years. We conclude that SDG&E was unreasonable in signing the Restated Agreement based upon the information available to SDG&E at the time it entered into the agreement.

The City in its brief takes SDG&E to task for entering into the Restated Agreement without conducting adequate studies. The City argues (1) SDG&E failed to study and analyze alternatives to the Restated Agreement, (2) SDG&E failed to analyze future trends in LSFO availability and prices, (3) SDG&E failed to analyze the Restated Agreement from the ratepayer's perspective, and (4) SDG&E chose to rely upon arbitrary and unreliable forecasts when evaluating the costs and benefits of the Restated Agreement. The City concludes that SDG&E was imprudent and unreasonable because the utility did not have sufficient information to enter into the Restated Agreement.

First, the City points out that in August, 1978, SDG&E had received the Gilbert Management Consultant's Report (Gilbert Report) introduced as Exhibit 2 in A.57780 and A.58263. The executive summary to this report is attached as Appendix A to D.90404, 1 CPUC 2d 596 (1979). The Gilbert Report found SDG&E's documentation and alternative studies in support of its fuel decisions to be deficient. The report further stated that more structured analysis and additional studies are needed to support SDG&E's actions.

The City argues that SDG&E failed to undertake the analysis recommended in the Gilbert Report. First, SDG&E did not study the contract and its terms to see if more favorable contract

provisions could be negotiated. The Gilbert Report had identified several unfavorable contract provisions which SDG&E did not even attempt to correct. Second, the utility's economic analysis did not analyze the alternatives of an underlift, sale, storage, or excess LSFO burn. The City asserts that each of these alternatives was a potential solution to the short-term LSFO oversupply. However, SDG&E chose to evaluate only the alternative of a contract extension. The City concludes that SDG&E was imprudent and unreasonable because it failed to comply with the Gilbert Report's recommendations.

Second, the City points out that SDG&E did not have forecasts of spot market LSFO availability when it decided to sign the Restated Agreement. The utility also did not have any estimates of spot market LSFO prices or contract prices for the years 1979-1983. The City maintains that without this forecast information SDG&E should not have entered into the Restated Agreement.

The City contends that the burden of any excess LSFO inventories in 1979 and 1980 would have been borne by SDG&E's shareholders since the carrying costs at that time were set in biennial general rate proceedings and were not recovered through ECAC. The City then points out that the two major costs examined by SDG&E were the carrying costs of excess LSFO inventory and the possible $1/bbl penalty for rejecting cheaper natural gas. Both costs analyzed by SDG&E were costs to the shareholder, not the ratepayer. The City argues that SDG&E never evaluated the reasonableness of the Restated Agreement from the ratepayer's perspective. For this reason, the City characterizes SDG&E's decision to sign the Restated Agreement as imprudent and unreasonable.

Finally, the City criticizes the gas forecast used by SDG&E in analyzing the Restated Agreement. The City point [*sic*] out that SDG&E's gas model had consistently understated the quantity of natural gas available for powerplant use in 1975, 1976, 1977, and

1978. In late 1978, SDG&E should have been well aware that its forecasting methodology was unreliable.

The City claims that SDG&E's inaccurate gas forecasts resulted in excess LSFO situations and oil sale losses totaling $11.3 million from 1976-1978. Despite this track record, SDG&E relied upon the same gas forecasting methodology to extend its contract with Tesoro. The City asserts that SDG&E's reliance upon a historically inaccurate gas forecasting methodology was imprudent and unreasonable.

In its reply brief, SDG&E responds to each of the City's arguments.

First, SDG&E argues that any analysis of the alternatives discussed in the City's brief would have been an idle act. The utility claims that none of the alternatives was a practical option in 1979.

Second, SDG&E contends that any long-term forecasts of LSFO availability and prices would have been useless information. The utility desired to reduce its contract volumes with Tesoro and had to agree to buy more oil from Tesoro in order to reduce volumes in 1979 and 1980. Furthermore, SDG&E maintains that any long-term forecasts of LSFO prices would have been too speculative.

Third, SDG&E maintains that its decision to enter into the Restated Agreement was based primarily upon ratepayer concerns. The purpose of the agreement was to lower short-term LSFO deliveries so that cheaper natural gas could be burned. The ratepayers would have received the short-term fuel savings of the Restated Agreement, not the shareholders.

Fourth, SDG&E asserts that it relied upon the best available gas forecasts when deciding to sign the Restated Agreement. The utility emphasizes that all gas forecasts at that time proved to be inaccurate. Moreover, SDG&E points out that the City has offered no other source of information which the utility could have turned to

back in 1979.

Despite SDG&E's protests, we are persuaded that the utility did not adequately study the long-term risks and liabilities posed by the Restated Agreement. Ignoring past experience, the utility chose to commit itself to long-term LSFO supplies without even considering the chance that despite pessimistic forecasts, natural gas or other alternative resources would become available. SDG&E chose instead to lock its resource mix into a take-or-pay LSFO contract through 1983 to avoid burdening its shareholders with the short-term carrying costs of excess LSFO inventory and a penalty for rejecting natural gas. Apparently, SDG&E's management also was unmoved by the Gilbert Report's recommendations which were known at that time. SDG&E's management was unreasonable in entering into the Restated Agreement.

VI. Tesoro Suspension Agreement

Since we have found the underlying 1979 Restated Agreement to be unreasonable, the issues raised by the 1982 Tesoro Suspension Agreement now are moot. Although we find that SDG&E produced a percipient witness on the 1982 issue and thus met its procedural burden of proof, our finding that the 1979 agreement was unreasonable eliminates the necessity to consider whether we would have found SDG&E's presentation on the 1982 contract adequate from a reasonableness perspective. However, the Suspension Agreement did mitigate the losses imposed by the Restated Agreement and will be considered in our eventual calculation of a disallowance.

Although we do not address the merits of staff's case attacking SDG&E's negotiation of the Suspension Agreement, we will state that SDG&E procedurally met its burden of proof on this matter. SDG&E provided all available documentation of its negotiation efforts and percipient witnesses to explain the transaction. The lack of more extensive documentation or the failure to call all possible percipient witnesses are matters left to SDG&E's judgment in the presentation of its case. This record is sufficient to

render a decision.

VII. Measure of Damages

We direct SDG&E and staff to prepare for the further hearings in this matter a calculation of the actual consequences of the 1979 Restated Agreement. For example, any realized fuel savings in 1979 and 1980 due to the lower contract volumes should be offset against the actual costs that accrued in 1981-1983 due to a less economical resource mix or from underlift payments. Other tangible costs or benefits may be used in the calculation.

From this calculation, we will determine an appropriate disallowance. In making the ratepayer whole for the consequences of SDG&E's decision to enter into the 1979 Restated Agreement, we will consider the financial impact of a disallowance on SDG&E since the ratepayer ultimately may bear some of that impact.

SDG&E and staff shall prepare and serve upon all parties testimony showing a calculation of the economic consequences of the Restated Agreement within 20 days from today.

Findings of Fact

1. In A.83-07-16, SDG&E requests adjustment of its ECAC rate, AER, and ERAM rate for a net revenue reduction of $57.3 million.

2. SDG&E's forecast resource mix is reasonable and should be adopted, apart from SONGS Unit 2 generation.

3. The staff's capacity factor for SONGS Unit 2 is consistent with the capacity factor adopted in D.83-09-025 for SCE.

4. SDG&E's calculation of an LSFO inventory does not adequately consider affirmative action by management in an emergency situation.

5. SDG&E's requested LSFO inventory level is excessive.

6. The staff's LSFO inventory level of 1,006,000 barrels is more reasonable than SDG&E's and should be adopted.

7. An ECAC rate decrease of .385¢/kWh, an AER increase of .174¢/kWh, and an ERAM rate decrease of .426¢/kWh are reasonable based on the adopted forecast and LSFO inventory level.

8. The above rate adjustments would produce a net revenue reduction of $65.5 million.

9. On November 22, 1983, the Commission issued D.83-11-091 in A.82-02-40 and A.82-03-63 which ordered SDG&E to reduce its ECAC rates by $38.9 million.

10. On December 12, 1983, SDG&E filed tariff schedules as ordered in D.83-11-091 which lowered its ECAC rate by .396¢/kWh.

11. Since an ECAC decrease of $38.9 million has already occurred, the net reduction of revenue of $65.5 million should be reduced by $38.9 million; SDG&E's ECAC rate should increase by .011¢/kWh rather than decrease by .385¢/kWh.

12. At the time SDG&E entered into the 1979 Restated Agreement, the utility had a long-term contract with HIRI for LSFO deliveries through 1984 with an option to increase deliveries in 1981, 1982, and 1983.

13. At the time SDG&E entered into the 1979 Restated Agreement, the utility projected fuel savings of just $500,000 from the agreement.

14. The 1979 Restated Agreement eliminated the flexibility in contract volumes SDG&E had in the HIRI contract and substi-

tuted an inflexible take-or-pay obligation to Tesoro.

15. The utility's economic analysis showed the 1979 Restated Agreement reduced the probability of excess LSFO in 1979 and 1980 but increased the probability of excess LSFO in 1981 and 1982.

16. At the time SDG&E entered into the 1979 Restated Agreement, the perceived benefits did not outweigh the risks shown in the utility's own analysis.

17. SDG&E was preoccupied with the possibility of a $1/bbl penalty for rejecting cheaper natural gas when it entered the 1979 Restated Agreement.

18. SDG&E entered into the 1979 Restated Aggreement [*sic*] to shield its shareholders from the carrying costs of an excess LSFO inventory in 1979 and 1980.

19. SDG&E did not conduct adequate studies before entering into the 1979 Restated Agreement.

20. SDG&E did not follow the recommendations of the Gilbert Report before entering into the 1979 Restated Agreement.

21. At the time SDG&E entered into the 1979 Restated Agreement, the utility had not considered the possibility that more natural gas would be available than was forecast even though the utility's gas forecasting methodology had consistently understated the volumes of natural gas that became available in 1975, 1976, 1977, and 1978.

21. Because the revision date of November 1, 1983 is past, this interim order should take effect on the date of issuance.

Conclusions of Law

1. SDG&E was unreasonable in entering the 1979 Restated Agreement with Tesoro because at that time the perceived benefits did not outweigh the risks shown in the utility's own economic analysis.

2. SDG&E was unreasonable because the utility failed to conduct adequate studies before entering into the 1979 Restated Agreement.

3. SDG&E was unreasonable because the utility attempted to shield the shareholders from Commission penalties and the short-term carrying costs of excess LSFO inventory at the long-term expense of the ratepayers.

4. SDG&E was unreasonable because the utility failed to adequately consider the possibility that greater quantities of natural gas than were forecast would become available despite its past experience in understating gas availability.

5. Further hearings should be held to determine the amount of any disallowance.

INTERIM ORDER

IT IS ORDERED that:

1. On or after the effective date of this interim order, SDG&E shall file, in conformance with the provisions of General Order 96-A, revised tariff schedules reflecting the following rate adjustments:

(a) ECAC rate increase of .011¢/kWh.
(b) AER increase of .174¢/kWh.
(c) ERAM rate decrease of .426¢/kWh.

The revised tariff schedules shall take effect 5 days after filing.

2. Consistent with our recent decision in SDG&E's general rate case (D.83-12-065) the System Average Percentage Change Method will be used to allocate the above revenue changes among customer classes.

3. SDG&E and staff shall prepare and serve on all parties testimony on the consequences of the 1979 Restated Agreement within 20 days from today. This testimony will be received as evidence in further hearings and will be the basis for determining an appropriate disallowance.

4. SDG&E's motion to overturn the ALJ's ruling on the 1979 Restated Agreement is denied.

This order is effective today.

Dated February 1, 1984, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

Decision 84-12-026 December 5, 1984

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN DIEGO GAS & ELECTRIC COMPANY, for authority to revise its Energy Cost Adjustment Clause Rate, to revise its Annual Energy Rate, and to revise its Electric Base Rates in accordance with the Electrical Revenue Adjustment Mechanism established by Decision 93892.	Application 83-07-16 (Filed July 8, 1983)

(See Decision 84-02-005 for appearances.)

Additional Appearances

Pillsbury, Madison & Sutro, by *Richard W. Odgers*, Attorney at Law, for San Diego Gas & Electric Company, applicant.

John W. Witt, City Attorney, by *Leslie J. Girard*, Deputy City Attorney, for the City of San Diego, interested party.

Rufus G. Thayer, Attorney at Law, for the Commission staff.

FINAL OPINION

I. SUMMARY OF DECISION

We order the San Diego Gas & Electric Company (SDG&E) to refund $45,060,000 to its ratepayers. In our interim opinion, Decision (D.) 84-02-005, we found that SDG&E's 1979 Restated Agreement (Agreement) with Tesoro-Alaskan Petroleum Corporation

(Tesoro) was unreasonable. This refund returns to the ratepayers some of the excessive fuel costs caused by the Agreement over the period July 1, 1982 to December 31, 1983. We do not disallow any expenses incurred over the January 1, 1979 to June 30, 1982 period to avoid adjustment of prior reported earnings for SDG&E.

We also grant the staff motion for disclosure and direct SDG&E to serve the documents which were the subject of the motion on all parties to this proceeding.

We deny SDG&E's motion to overturn the Administrative Law Judge's (ALJ's) evidentiary rulings. The ALJ properly excluded SDG&E prepared testimony which simply reargued the reasonableness of the Agreement. The ALJ also properly admitted staff testimony which sought to measure the actual consequences of the Agreement.

II. BACKGROUND

On February 1, 1984, the Commission issued an Interim Opinion, D.84-02-005, which found, inter alia, that SDG&E's Agreement with Tesoro was unreasonable. The Commission ordered that further hearings should be held to receive evidence on the actual consequences of the Agreement and the financial impact on SDG&E of a disallowance. The Commission wanted to consider this additional evidence before a disallowance is determined.

On February 3, 1984, the ALJ held a second Prehearing Conference (PHC) to schedule the further hearings ordered in D.84-02-005. At the start of this PHC, SDG&E made a motion to remove the ALJ as the assigned hearing officer for the proceeding. SDG&E presented a written Motion to Disqualify ALJ and asked that the PHC be continued until the motion was ruled upon. The ALJ denied SDG&E's request for a continuance and took the Motion to Disqualify ALJ under submission. A schedule was set for the mailing of prepared testimony and the further hearings. The ALJ also ordered SDG&E to disclose certain documents and other

information related to fuel procurement for the period 1975-1983.

On March 1, 1984, SDG&E filed a Motion For Establishment of 10 Day Rule (Rule 68) As Basis For Filing of Prepared Testimony In Penalty Phase Hearings. The ALJ instructed SDG&E to mail any completed testimony under the schedule set at the second PHC and to mail any additional testimony before the next PHC.

On March 2, 1984, SDG&E filed an Application For Rehearing of D.84-02-005. This application was referred to the Appellate Section of the Commission's Legal Division.

On March 5, 1984, the assigned Commissioner issued a ruling denying SDG&E's Motion To Disqualify ALJ. At the Commission's Meeting on March 7, 1984, the assigned Commissioner reported his ruling to the full Commission.

On March 19, 1984, the ALJ held a third PHC. At this PHC, the Commission staff asked for clarification on the scope of this phase of the proceeding. The staff argued that much of the testimony prepared by SDG&E for this phase of the proceeding relitigated issues already decided in the Interim Opinion, D.84-02-005. The staff then moved to exclude SDG&E's prepared testimony from this phase of the proceeding. The City of San Diego (City) joined in staff's motion. SDG&E responded that it was not attempting to relitigate D.84-02-005 in its prepared testimony and requested leave to submit by letter legal authorities supporting its position on the appropriate measure of damages. The ALJ allowed all parties to submit letters on the relevant legal authorities and took staff's motion under submission. In addition, the ALJ set a new hearing schedule to allow time for review of the parties' letters and a ruling on staff's motion.

On April 9, 1984, hearing was held to receive the testimony of two SDG&E witnesses: William A. Abrams and R. Lee Haney. Staff and City cross-examined these two witnesses.

On April 25, 1984, SDG&E filed a Petition Requesting Commission Ruling on Motion To Disqualify ALJ. In this petition, SDG&E requested that the full Commission approve or deny the assigned Commissioner's ruling issued March 5, 1984.

On May 2, 1984, the ALJ issued a ruling granting staff's and City's motion to exclude the prepared testimony of SDG&E witnesses John O'Leary, Arlon Tussing, and William Hughes. The ruling also excluded portions of SDG&E witness Michael Niggli's testimony. Staff had moved for the exclusion of Niggli's entire prepared testimony.

By letter dated May 21, 1984, SDG&E asked that the Commission defer a denial of its Application for Rehearing until after the Commission issues a decision on a disallowance. However, if the Commission was inclined to grant rehearing, then SDG&E said a deferral would be unnecessary. This request also was referred to the Appellate Section.

Additional hearings were held on May 22-24 and June 1, 1984. Testimony from SDG&E's remaining witness, Michael Niggli, and staff's witnesses, Russell Copeland and Ray Czahar, were received during these hearings. In addition, SDG&E witness Abrams sponsored some rebuttal testimony.

On May 22, 1984, the ALJ informed SDG&E that the full Commission at its March 7, 1984 Meeting already had confirmed the assigned Commissioner's ruling on SDG&E's Motion To Disqualify ALJ. Therefore, SDG&E's April 25, 1984 Petition Requesting Commission Ruling On Motion To Disqualify ALJ was moot. This is apparently in error since no minute order reflecting this action was entered. The ALJ further advised SDG&E that it must file an appeal of the assigned Commissioner's ruling if it intended to pursue this matter any further. No such appeal was filed nor was the matter raised in briefs. We hereby affirm the assigned Commissioner's ruling.

On the last day of hearing, June 1, 1984, SDG&E orally requested that the ALJ issue a proposed report pursuant to Rule 78. Rule 78 provides that a written petition for a proposed report shall be filed before the conclusion of hearing. However, staff and City did not object to SDG&E's oral request. At this time, SDG&E also stated that the company previously had given documents to Commissioners or their aides which had not been served upon the parties. Staff and City asked that these documents be produced and served upon the parties. The ALJ took this motion to compel discovery under submission.

Opening briefs were filed by SDG&E, staff, and City on July 9, 1984. Closing briefs were filed on July 23, 1984. The ALJ's Proposed Report was issued on September 14, 1984. Exceptions to the report were filed by SDG&E, staff, and City on October 4, 1984. Oral argument before the Commission en banc was held on October 29, 1984.

III. SUMMARY OF EVIDENCE

Additional evidence was received on two subjects: (1) the financial impact of a disallowance, and (2) disallowance calculations based on the actual consequences of the Agreement.

A. Financial Impact

1. SDG&E Evidence

SDG&E sponsored two witnesses on the financial impact of a disallowance: William Abrams and R. Lee Haney. Abrams is a vice president at Duff and Phelps, Inc., an investment research organization. Haney is a vice president and treasurer of SDG&E. Both witnesses testified that a disallowance based on the Agreement will have an adverse impact on SDG&E's credit rating and cost of capital.

Abrams explained how Duff and Phelps determines credit ratings and how SDG&E's credit rating would be affected by a disallowance. Abrams testified that credit ratings are based primarily on the financial integrity of the company. He stated that the stability and protection of the company's income stream are very important in measuring a company's financial strength. Abrams also testified that regulation is a key factor in judging a utility company. Regulation is evaluated by the company's ability to earn a realistic rate of return, the cash quality of earnings, the stability of earning trends, and moderation of the company's need to finance externally. Both the historical and the forecast financial performance of the company are considered here.

Abrams testified that recent Commission actions have raised concerns in the investment community about the company's financial risk. Abrams singled out the 1983 change of the Annual Energy Rate (AER) from 2% to 8%, the prudency review of SONGS 2 and 3 construction costs, the target capacity factor for SONGS 2, the rate base treatment of SONGS 1, and the rate-making treatment of the Sun Desert plant site as examples of increased financial risk to SDG&E.

In Abrams' opinion, a disallowance due to the Agreement will have two significant impacts on SDG&E. First, a disallowance would raise interest expense since the common equity base would be reduced causing the capital structure to be more leveraged. Second, the investment community would regard a disallowance as a major signal of regulatory deterioration in California. This perception would engender the belief that SDG&E faces increased risk on all other matters before the Commission. Abrams further stated that this adverse opinion on California regulation could be applied to all electric and/or gas utilities in California, not just SDG&E.

Abrams concluded that any adverse decision in this proceeding would trigger a special review of SDG&E's credit rating. He warned that if SDG&E's rating is lowered, then SDG&E's financing

costs could increase for some time.

Haney testified that any disallowance based on the Agreement will cast a cloud over the financial standing of SDG&E and every other California utility. In Haney's opinion, the financial community will perceive that the Commission may at any time penalize a utility for earlier actions even when those actions have gone unchallenged for years.

Haney also testified that investors seek out utilities for their stability in earnings. In his opinion, a disallowance in this proceeding could lead to renewed earnings volatility and could even precipitate a reversal of the company's steady financial progress.

Haney testified that any disallowance in this proceeding should be considered with the other significant regulatory issues facing SDG&E. The Commission should be aware that the combination of adverse decisions on the retention of SONGS 1 and the Sun Desert site in rate base and the prudency of SONGS 2 and 3 construction costs could have a harmful impact on the company's financial standing.

Haney suggested that if the Commission desires to minimize the impact on the company's cost of capital, then the earnings cap of 120 basis point adopted in D.83-08-048 could be used in this proceeding. This earnings cap, using the current authorized rate base of $1.7 billion and a 43% common equity ratio, is about $8.8 million.

Abrams also filed some rebuttal testimony in which he tried to quantify the impact of a disallowance on SDG&E after assuming that a refund had been ordered in 1983. If a disallowance of $65 million had been ordered by the Commission, Abrams estimated that the company's interest expense would have increased by $14.4 million to maintain a 3.0 times interest coverage. Abrams then concluded that such a refund to ratepayers would be a short-lived boon and a long-term increase to utility rates because of the

increased interest expense.

2. Staff Evidence

Staff presented one witness on the financial impact of a disallowance on SDG&E, Ray Czahar. Czahar analyzed the impact of an assumed $70 million disallowance. He estimated that the after-tax impact of a $70 million disallowance on SDG&E would be $34.3 million.

Czahar first reviewed SDG&E's key financial indicators for the period 1978-1982. He then forecast SDG&E's cash generation capital requirements and external financing for the period 1984-1988. From this historical and prospective analysis, he determined that SDG&E's financial record has shown steady improvement from 1978-1982 and should continue to improve in future years.

Czahar then analyzed the impact of a $34 million reduction in 1984 common equity earnings on SDG&E. He found that this reduction would not severely alter SDG&E's financial position after 1984. He also found that a $70 million disallowance will not damage SDG&E's credit worthiness so that the utility's ability to deliver safe and reliable service to its customers is threatened.

In rejoinder to Abrams' rebuttal testimony, Czahar testified that if one includes the savings from a lowered common equity base in Abrams' calculation, then the net revenue increase attributable to a $65 million disallowance should amount to $2.2 million not $14.4 million. Czahar stated this would be a one-time revenue increase.

B. Disallowance Calculations

SDG&E presented one witness, Michael Niggli, on disallowance calculations. Staff also presented one witness, Russell Copeland, on this subject.

1. SDG&E Calculations

SDG&E's witness testified that although the company has prepared several calculations, the company believes that no disallowance is appropriate. After presenting each calculation, Niggli added the disclaimer that the calculation should not be used as the basis for a disallowance since the company believes no disallowance is appropriate. The company's efforts throughout this phase of the proceeding were devoted to a refutation of any evidentiary basis for a disallowance.

The first calculation prepared by SDG&E was $97 million. Niggli explained that this figure represented his initial estimate of the actual costs and benefits of the Agreement. In making this calculation, Niggli assumed that the different oil volumes taken under the Agreement could have been replaced by natural gas. Under this assumption, the Agreement could have increased SDG&E's fuel costs by $97 million.

Niggli immediately pointed out that his $97 million calculation was based upon the erroneous assumption that all additional oil volumes under the Agreement could have been replaced with natural gas. Niggli testified that due to supply flow limitations and power plant gas availability, natural gas could not have completely replaced oil in late 1981 and early 1982. If the actual availability of gas is considered, then his $97 million calculation is reduced to $47 million. The present value of the benefits and detriments underlying this figure, valued as of January 1, 1984, is $33 million.

In supplemental testimony, Niggli reduced this $33 million calculation by subtracting prior Commission disallowances of SDG&E fuel costs. Niggli subtracted a fuel disallowance of $6.88 million already ordered in D.82-12-056 and $13 million in unrecovered fuel oil carrying costs. These two adjustments on a present value basis amount to $26.5 million. The $33 million calculation minus these costs is $6.55 million.

Last, Niggli points out that the record already contains data which could be used as a punitive disallowance. In SDG&E's 1979 analysis of the Agreement's costs and benefits, the company had assumed a 50% probability of a $1 barrel penalty for rejected natural gas. Therefore, SDG&E maintains that an acceptable method for calculating a disallowance would be a $.50/barrel penalty for each additional barrel of oil (9.1 million barrels) the company agreed to take under the Agreement. Under this method, the disallowance would amount to $4.55 million. Again, SDG&E emphasizes that although the method exists, it does not believe any disallowance is justified or appropriate.

2. Staff Calculation

Staff witness Russell Copeland recommends a disallowance of $65,008,000.

Copeland first assumed that SDG&E had not signed the Agreement and instead received the low sulfur fuel oil (LSFO) volumes specified in the prior 1974 Tesoro contract, as amended. Copeland further assumed (1) that SDG&E could have burned all available natural gas from 1979-1983, (2) that SDG&E could have disposed of any excess LSFO on the spot market, and (3) that SDG&E could have acquired any needed LSFO above contract volumes on the spot market.

Under the above assumptions, Copeland calculated what SDG&E's total fuel costs would have been for the period 1979-1983 without the Agreement. The natural gas burn and the price of natural gas were derived from SDG&E's operating records and confirmed by data requests to SDG&E's natural gas supplier, the Southern California Gas Company. The amount of natural gas available to SDG&E from 1979-1983 and the price of that gas were taken from these recorded data. The disposal cost of LSFO and the acquisition price of LSFO on the spot market were derived from Lundberg Survey Inc. monthly reports on LSFO prices in Southern California. Here Copeland found that a range of LSFO

prices is shown in the Lundberg reports. If one chose from this range the LSFO prices most favorable to SDG&E (high buying price, low selling price), Copeland found that a disallowance of $26,954,000 could be calculated. However, if one selected the LSFO prices least favorable to SDG&E (low buying price, high selling price), then a disallowance of $114,446,000 could be calculated. The range between these "minimum" and "maximum" calculations is $87.5 million. Realizing that this variation was too large, Copeland refined his analysis. He compared SDG&E's recorded LSFO sales with Lundberg reported prices at the time of each sale. He found that SDG&E had sold its LSFO at a price 70¢ per barrel below the average sales price shown in the Lundberg reports. As a result, Copeland used the Lundberg average price minus 70¢ per barrel as SDG&E's disposal cost. Since Copeland could not find any recorded LSFO purchases by SDG&E to compare with the Lundberg reported prices, he used the Lundberg average price as SDG&E's acquisition price. With these refined disposal costs and acquisition prices for LSFO, Copeland calculated his recommended "mid-range" disallowance of $65,008,000. This figure represents the difference between SDG&E's recorded fuel costs with the Agreement and what SDG&E's fuel costs would have been without the Agreement under Copeland's assumptions.

Copeland also testified that under this method he has subtracted from his recommended disallowance a prior fuel-related penalty of $6.88 million already imposed by the Commission. (See D.82-12-056, pp. 31, 33.)

IV. POSITIONS OF THE PARTIES

A. SDG&E

SDG&E believes that no disallowance or penalty can be jusitified. Although the Commission in its Interim Opinion, D.84-02-005, asked for evidence on the actual consequences of the Agreement, SDG&E argues that the Commission has failed to identify a standard or alternative course of action which the company should have followed against which the actual consequences of the

Agreement can be measured. For this reason, SDG&E submits the actual consequences of the Agreement cannot be determined.

SDG&E contends that the ALJ erred in excluding SDG&E's prepared testimony on the course of action that a reasonable and properly motivated utility would have followed in 1978-1979. Without this type of evidence, SDG&E submits that the Commission cannot fix a disallowance.

SDG&E further contends that the ALJ erred in admitting staff's testimony. SDG&E argues that the staff's calculated disallowance is based on an alternative course of action that realistically was not available to SDG&E. In addition, SDG&E asserts that the staff's disallowance is not limited to the consequences of the Agreement. SDG&E believes that the staff's evidence cannot serve any purpose in calculating the actual consequences of the Agreement and should have been stricken from the record.

Finally, SDG&E submits that any disallowance ordered by the Commission must be proportional to the wrongdoing identified in D.84-02-005. SDG&E states that the only wrongdoing identified in the decision was improper procedures and motivations. SDG&E argues that a penalty for improper procedures and motivations should not exceed the $4.55 million shareholder burden which SDG&E purportedly sought to avoid when it entered into the Agreement.

B. Staff

Staff submits that its proposed $65 million disallowance is the only calculation which covers all actual consequences of the Agreement. Staff further argues that its recommended disallowance should be adopted by the Commission since its financial analysis shows that a disallowance of $70 million will not have any lasting financial impact on SDG&E or on the ratepayers.

Staff contrasts SDG&E's evidence with its own showing on the financial impact of a disallowance.

Staff first describes SDG&E witness Abrams' testimony as nothing more than a general description of the securities rating procedures at Duff and Phelps. Staff then characterizes SDG&E witness Haney's testimony as just a complaint about the Commission's adverse decision on the Agreement.

Staff asserts that its own witness Czahar has presented a well-disciplined analysis consisting of an historical evaluation of SDG&E's key financial indicators from 1978-1982, a forecast of cash generation, capital requirements, and external financing for the period 1984-1992, and a forecast of pre- and after-tax interest coverage from 1984-1988. From this analysis, the staff has concluded that SDG&E's financial outlook is very promising. SDG&E's financial position is so secure that staff believes a disallowance of $70 million will not severely alter SDG&E's financial standing after 1984. If a $70 million disallowance was imposed by the Commision [*sic*] in 1984, staff has found that although the utility's earnings and interest coverage would be lowered in 1984, SDG&E's basic financial position after 1984 would be largely unaffected.

Staff asserts that its affirmative forecast has been substantiated by SDG&E's directors. Staff points out that on May 21, 1984 the directors increased the quarterly common stock dividend 7.1% from 49¢ per share to 52.½¢ per share. Staff notes that SDG&E's directors authorized this dividend increase because they felt the company's financial position had improved despite the uncertainties of a disallowance due to the Agreement and the prudency review of SONGS 2 and 3 construction costs.

Staff submits that the inescapable conclusion to be drawn from the evidence in the record is that a disallowance on the order of $70 million will not materially impair SDG&E's improving financial

prospects nor result in substantial adverse consequences to the ratepayer.

Staff next addresses the various calculations on the actual consequences of the Agreement.

Staff states that despite the Commission's clear directive in D.84-02-005, SDG&E has not presented any meaningful calculations in this phase of the proceeding. Staff claims that SDG&E ignored D.84-02-005 and instead chose to produce testimony by several consultants attacking the Commission's decision. Staff submits that this testimony was properly excluded by the ALJ.

In contrast to SDG&E's showing, staff asserts that its witness Copeland has presented a thorough analysis covering all possible consequences of the Agreement. Staff claims it has meticulously reviewed the company's operations on a day-by-day basis for the period 1979-1983. Staff claims that in this review it has compared SDG&E's actual recorded fuel costs with the Agreement against an extrapolation of the company's fuel costs without the Agreement. The staff chose not to look at the Agreement by itself because the source of LSFO (HIRI, Tesoro, spot market) is not distinguishable after it enters SDG&E's inventory. The staff believes that its method, unlike the company's simplistic calculations, has properly accounted for all consequences that may have flowed from the Agreement.

Staff maintains that the utility has not presented any calculation as an affirmative showing. Instead, SDG&E attempts only to disassociate itself from the $97 million calculation it had previously disclosed to the Commission. Staff notes that the company's witness has disavowed some of his own calculations when he testified that his $97 million figure was based upon incorrect assumptions.

Staff submits that the only well-reasoned calculation of a disallowance has been provided by the staff. The company's

disavowal of its own figures simply underscores the unreliable methodology used by the company. The staff concludes that its disallowance of $65 million should be adopted by the Commission.

C. City

City believes that the staff presented the more credible evidence on the financial impact of a disallowance and on the consequences of the Agreement. Accordingly, City submits that the staff's recommended disallowance should be adopted. Alternatively, City suggests that the Commission may impose a disallowance based upon the economic difference between the Agreement and the underlying 1974 contract with Tesoro, as amended.

City asserts there is a need for a substantial disallowance in this proceeding. City concedes that SDG&E has changed its fuel procurement practices since 1979; however, City contends that a substantial disallowance is necessary to ensure that the company keeps current with the most advanced techniques. City also states that the company's shareholders should bear the economic burden of the Agreement so they will exert pressure on SDG&E's management to continually update the company's fuel procurement procedures.

City divides the financial impact of a disallowance into two categories: (1) the immediate dollar impact on SDG&E's balance sheet and the concurrent effect on the company's ability to provide service, and (2) the effect on the market's perception of the company's financial stability and the concurrent long-term effect on the company's ability to raise capital. City finds that while (1) is easy to measure, (2) is relatively difficult to determine.

City says the immediate impact of a $65-70 million disallowance on SDG&E's balance sheet has been shown in staff witness Czahar's direct testimony and SDG&E witness Abrams' rebuttal testimony. City finds staff's testimony to be more credible for several reasons. First, Czahar analyzed the impact of a disallow-

ance in 1984 and later years through 1992. On the other hand, Abrams evaluated only the impact of a refund ordered in 1983. He conducted no analysis for 1984 or future years. Second, City points out Abrams' calculation of a $14 million revenue increase to cover the increased interest expense was wrong. Cazhar saw that Abrams had failed to include the financial consequences of a reduction in retained earnings. When this factor is considered, Abrams' calculated figure of $14 million drops to $2.2 million. City notes that Czahar's correction of Abrams' calculation was not challenged by SDG&E. Accordingly, City submits that Czahar has proven to be the more accurate and credible witness on this matter. Therefore, the Commission should find that a $70 million disallowance will not affect SDG&E's financial position.

Regarding the market's perception of a disallowance, City emphasizes that two major bond rating houses recently have upgraded SDG&E's rating on bonds, debt, and stock. These agencies raised SDG&E's credit ratings knowing that a disallowance as high as $100 million has been suggested in this proceeding. City also notes that SDG&E's stock has continued to sell above book value during this proceeding. To City, the financial market has demonstrated that SDG&E's financial outlook is sound despite the prospect of a substantial disallowance in this proceeding.

City believes there are two ways to calculate the actual consequences of the Agreement.

First, City asserts that staff witness Copeland's calculated disallowance fairly measures all the consequences of the Agreement. City finds that Copeland has compared the actual events under the Agreement with the course of action SDG&E reasonably could have followed without the Agreement. City asserts that each of Copeland's assumptions is reasonable. In City's view, SDG&E should have burned all natural gas that was available and sold more expensive LSFO on the spot market. City asserts that Copeland's recommended disallowance of $65 million is reasonable and should be adopted.

City describes a second way of calculating a disallowance as the economic difference between the Agreement and the underlying 1974 contract, as amended. In its brief, City has calculated this difference as $74 million based on data drawn from staff and SDG&E exhibits in the record.

City submits that a disallowance of $65 million or $74 million should be adopted by the Commission.

V. ISSUES

The issues raised in this phase of the proceeding are as follows:

1. Should the Commission's fixing of a disallowance be tempered by the financial impact on SDG&E and its ratepayers?
2. Which disallowance calculations best represent the actual consequences of the Agreement?
3. Did the ALJ err in excluding the prepared testimony of SDG&E's hired consultants and in admitting staff's testimony on the consequences of the Agreement?
4. Should the motion of staff and City to compel disclosure of documents be granted?

VI. DISCUSSION

A. Financial Impact

In our Interim Opinion, D.84-02-005, we stated at page 22 that ". . . we will consider the financial impact of a disallowance on SDG&E since the ratepayer ultimately may bear some of that impact." In response to this statement, both staff and SDG&E have presented testimony and evidence on this matter. However, the nature of the two presentations is very different.

SDG&E's direct testimony did not include any specific analysis of SDG&E's financial position or of the impact of a particular disallowance on SDG&E. Instead, this testimony was limited to general predictions of adverse consequences which lacked any reference to SDG&E's financial circumstances. For example, both witnesses proclaimed that a disallowance in this proceeding would lead to a market perception of regulatory decline in California which could adversely affect all California utilities. Clearly, both witnesses sought to avoid any examination of SDG&E's current financial position. One witness, Abrams, initially testified that it would be "impossible" to quantify the impact of a disallowance in advance. However, he later proceeded in his rebuttal testimony to quantify the impact of a $65 million refund made in 1983.

Even the general observations of financial decline offered by SDG&E's witnesses were made without the most rudimentary analysis. For example, one SDG&E witness testified that the Commission's Interim Opinion, D.84-02-005, signaled a change in the standard of review in California. Yet this same witness conceded that he had not read any other Commission decision which addressed the reasonableness and prudency of a utility's actions. An SDG&E witness also testified that the Commission's D.83-08-048 which raised SDG&E's AER from 2% to 8% increased SDG&E's risk of loss *without* any offsetting opportunity for gain. Yet, he made this judgment without conducting any review of the gains or losses experienced by SDG&E under its 2% AER even though he agreed this would be one analytic way of determining whether SDG&E actually faced any increased risk under the revised AER procedures. (It is interesting to note that on August 13, 1984, the Southern California Edison Company filed a Comparative AER Analysis For the Period May 1, 1983 through May 31, 1984 as ordered in D.83-08-048 and reported that its recorded AER revenues exceeded adopted revenues by $50 million. Clearly, the opportunity for utility gains under the Commission's revised AER procedures is substantial.)

SDG&E's predictions of financial gloom and doom have not been substantiated by the investment community. Rather, on April 4, 1984, the Wall Street Journal reported that both Moody's Investors Service, Inc. and Standard & Poor's Corp. raised SDG&E's credit ratings. These two rating agencies increased SDG&E's ratings with the full knowledge that a substantial disallowance could be imposed in this proceeding. SDG&E's Annual Report for 1983 which was released some time in March 1984 states that SDG&E expects the ALJ to recommend a substantial disallowance. And SDG&E representatives had visited both rating agencies several weeks before the upgrade was announced and informed the agencies that possible penalties as high as $100 million have been suggested in this proceeding. Clearly, both agencies determined that despite the prospect of a substantial disallowance in this proceeding, SDG&E's improved financial position warranted higher credit ratings.

The staff's presentation was markedly different from SDG&E's showing. Staff performed a detailed review of SDG&E's past financial performance and prepared an objective forecast of SDG&E's capital requirements in future years. Staff analyzed the impact of an assumed $70 million disallowance and found that a disallowance of this magnitude will not severely alter SDG&E's basic financial position after 1984. During cross-examination, the staff witness further stated that a disallowance up to $120 million will not have an adverse financial impact on SDG&E. In his opinion, SDG&E is in an excellent financial position with or without a disallowance because the construction of SONGS 2 and 3 now is completed and because SDG&E is able to normalize its income taxes.

The staff's presentation on the financial impact of a disallowance was complete and convincing. We are persuaded that SDG&E's financial position is so secure that our fixing of a disallowance up to $70 million should not be constrained by financial impact considerations.

We note that SDG&E submitted rebuttal testimony to the staff presentation after cross-examining the staff witness. In this testimony, SDG&E attempted to show that the adverse impact on the ratepayer of a $65 million disallowance in 1983 could be quantified at some $14.4 million a year in increased interest expense. The staff demonstrated that this figure was substantially overstated since it failed to include the decreased revenues due to lower equity costs. Even using SDG&E's assumption of the required interest coverage, the correct figure, taking into account lower equity costs and higher debt costs, is only $2.2 million. We recall that SDG&E's witness during cross-examination on his direct testimony stated that a disallowance would lower equity revenues and raise debt costs. However, his later submitted rebuttal testimony focused only on the higher debt costs. The failure of this witness to present a complete calculation reflects adversely on his assertions. Our findings on this issue are made with great confidence in the staff presentation. However, even absent the staff showing, we would find SDG&E's presentation to be unreliable and lacking in credibility.

B. Disallowance Calculations

We will address SDG&E's, staff's, and City's disallowance calculations in turn.

1. SDG&E

SDG&E has calculated figures ranging from $97 million to $4.55 million.

The $97 million figure was the first calculation made by SDG&E witness Niggli. This figure is based on the assumption that the lower and higher LSFO volumes stated in the Agreement respectively were replaced by natural gas and displaced available natural gas. However, Niggli subsequently found that the higher LSFO volumes in late 1981 and early 1982 could not have completely displaced natural gas. Therefore, according to Niggli, the $97

million ovestates [*sic*] the detriments attributable to the Agreement in late 1981 and early 1982.

The next figure explained by Niggli is a $33 million calculation. This figure takes into account the limited availability of natural gas in late 1981 and early 1982. In addition, the figure includes LSFO sales losses incurred during this same timeframe which are attributable to the Agreement. This figure purportedly is based upon a comparison of 1974 contract volumes, as amended, with the actual Tesoro deliveries. (However, the final contract volumes shown in Niggli's work papers do not match the recorded Tesoro deliveries shown in the company's data response.) Finally, for this calculation Niggli used present worth factors to value all calculated benefits and detriments of the Agreement on a January 1, 1984 basis.

We find several problems with this second figure. Apart from his inclusion of LSFO sales losses, it is apparent that Niggli has focused only on adjustments which will reduce his $97 million figure. Niggli testified that an exhaustive search and review of SDG&E's operating records revealed that natural gas could not have completely replaced the additional LSFO obligations assumed in the Agreement for late 1981 and 1982. Recognition of this limitation reduced the calculated detriments of the Agreement. On the other hand, Niggli declined to make similar adjustments for the "benefit" period of 1979 to mid-1981 when LSFO contract volumes were lowered.

For example, in January 1979, SDG&E did not burn any natural gas. Nonetheless, Niggli has included a benefit of $1,051,830 for this month based on the erroneous assumption that a lower LSFO volume in this month enabled SDG&E to burn more gas. In January 1981, SDG&E burned 267 MMcf of natural gas equivalent to about 40,000 barrels of LSFO. Yet Niggli has included a benefit in this month of replacing 164,300 barrels of LSFO with natural gas. Thus, he has overstated the actual benefits of the Agreement.

Furthermore, Niggli testified that he did not consider LSFO inventory levels in his calculation. If SDG&E had unused tank capacity, the company would have been able to burn available natural gas whether or not it was obligated to receive higher or lower LSFO volumes under the Agreement. Therefore, if SDG&E had enough tank capacity to store excess LSFO, the Agreement's lower volumes from 1979 to mid-1981 would not have enabled a greater gas burn.

Niggli did not consider such actual operating conditions which would have lowered his calculation of the benefits from the Agreement. Thus, Niggli has not applied a consistent methodology in deriving his $33 million figure. This figure is substantially understated since the calculated benefits have not been adjusted to reflect actual operating conditions in the same manner in which the calculated detriments were adjusted.

In his supplemental testimony, Niggli made two adjustments to his $33 million figure. First, he subtracted a prior disallowance of $6.88 million ordered in D.82-12-056 because the staff in its calculation had deducted this amount. Although Niggli in his rebuttal testimony completely repudiated the staff's methodology, he suggests that his figure should be adjusted in the same way staff's calculation was. Second, Niggli contends that some $13 million in unrecovered LSFO inventory carrying costs should also be recognized and subtracted. As discussed earlier, Niggli did not consider LSFO inventory levels in his method. Yet despite this omission he suggests it is reasonable to subtract the unrecovered carrying costs of excess LSFO to further reduce the $33 million figure. Both of these adjustments to the $33 million figure reveal SDG&E's intent to engage in whatever maneuvers that will lead to a lower disallowance figure. The inconsistent positions taken by SDG&E confirm our belief that SDG&E's evidence should be viewed with skepticism.

The last figure offered by Niggli is $4.55 million. As stated earlier, this figure is based on the shareholder burden that SDG&E

was concerned about when it was evaluating the proposed Agreement. Since we have already found in D.84-02-005 that the Agreement was unreasonable, it would be incongruous to limit the disallowance to an assumption in the underlying company analysis.

First, the 50% probability of a penalty assumed by SDG&E i inapplicable here. SDG&E's estimation of the likelihood of a Commission penalty is not binding on or relevant to the Commission's fixing of a disallowance.

Second, the one-dollar-per-barrel difference between LSFO and gas prices assumed by SDG&E as the potential penalty was just plain wrong.

SDG&E asserts that this difference between the Tesoro price for LSFO and the GN-5 rate for gas is in accord with D.90404, 1 CPUC 2d 596 (June 5, 1979). That decision addressed the reasonableness of certain LSFO sales losses in the record period June 1, 1977 to June 30, 1978. The Commission found that SDG&E had incurred an LSFO sales loss of $5,018,800 but realized some $19.3 million in excess gas revenues. The Commission then decided that SDG&E's electric ratepayers should not bear the burden of the LSFO sales loss and disallowed this amount minus the fuel cost savings from burning gas. (1 CPUC 2d at 629-630.) In effect, SDG&E's electric ratepayers were made indifferent to this transaction. And since at that time a Supply Adjustment Mechanism (SAM) was not in effect, SDG&E, not its gas ratepayers, retained the $19.3 million in excess gas revenues reduced by the disallowed sales loss. SDG&E's gas ratepayers were not affected by the transaction. Thus, the Commission previously was simply addressing the question of whether SDG&E should have retained all the benefits of the LSFO sale without bearing any of the costs.

The Agreement was made in an entirely different set of circumstances. First, a SAM was in effect; therefore, any excess gas revenues flowed through to the gas ratepayers and were not

retained by SDG&E. Second, the Agreement obligated SDG&E to purchase additional LSFO which could displace less expensive gas. The Agreement raised SDG&E's total fuel costs. D.90404 addressed a sale of excess LSFO so that SDG&E could burn more gas. This transaction lowered the company's total fuel costs.

In D.90404, the Commission ensured that the ratepayers were made indifferent to the LSFO sales loss. To reach the same result for the ratepayers in this proceeding, the Commission must consider the actual cost of gas to SDG&E or the G-61 commodity rate. The difference between the G-61 rate and the Tesoro price during the period SDG&E was reviewing the proposed Agreement, January 1979 to May 1979, was:

	$ 7.54/bbl	January 1979
	$ 7.26/bbl	February 1979
	$ 8.02/bbl	March 1979
	$ 8.26/bbl	April 1979
	$ 8.56/bbl	May 1979
Total	$39.64/bbl	
Average	$7.93/bbl	

If the average price difference is inserted in Niggli's suggested method, the shareholder burden which SDG&E's management should have foreseen under the Agreement is 9.125 million barrels × $7.93/bbl = $72,361,000.00. A disallowance of this amount would be proportional to the wrongdoing committed by SDG&E and would be an accurate measure of the risk that should have been foreseen in SDG&E's analysis of the proposed Agreement.

In summary, SDG&E's first calculation of $97 million is based on a consistent method which uses the different contract volume requirements; however, it does not reflect actual operating conditions in the period 1979-1983. SDG&E's subsequent adjustment of this figure to reflect actual operating conditions in late 1981 and early 1982 was not based on a consistent methodology since similar adjustments were not made for the "benefit" period. Furthermore, the work papers for this adjusted figure conflict with

SDG&E's data responses. Finally, SDG&E's last method of calculating a disallowance relies upon the company's earlier analysis of the Agreement. However, this analysis used incorrect assumptions which, if corrected, yield a disallowance figure of $72 million.

2. Staff

Staff recommends a disallowance of $65 million. As discussed earlier, this figure is based on a reconstruction of SDG&E's fuel costs for the period 1979-1983 absent the Agreement.

SDG&E protests that the staff's method goes far beyond the actual consequences of the Agreement. We agree that staff has calculated "credits" and "penalties" on LSFO quantities which exceed the volume changes negotiated in the Agreement. However, this approach does not lead us to SDG&E's conclusion that the calculated disallowance is meaningless. Rather, we conclude that the staff method is a consistent calculation of what SDG&E's fuel costs would have been if SDG&E had burned all available natural gas from 1979-1983.

Staff determined that the primary consequence of the Agreement was the rejection of available natural gas from SDG&E's fuel mix. Staff decided not to confine its analysis to the incremental volume changes of the Agreement because staff was unable to determine the supplier source of LSFO in SDG&E's inventory and in its LSFO burn. Staff, unlike SDG&E, was unwilling to assume that the Agreement's lower LSFO contract volumes necessarily enabled a higher gas burn and that the Agreement's higher contract volumes necessarily resulted in gas rejections. Instead, staff predicated its method on SDG&E's recorded LSFO burn and the recorded availability of natural gas. Reliance on these two factors eliminates the need to determine whether the Agreement's incremental volumes actually replaced or displaced natural gas. Instead, the staff was able to calculate SDG&E's fuel costs based on a maximum gas burn. The staff method implies that the Agreement turned SDG&E's management away from a gas optimization

fuel mix although it would have been reasonable for SDG&E to manage its resources in this manner from 1979-1983.

The critical assumptions underlying the staff figure are the disposal cost of LSFO and the acquisition price of LSFO in the spot market. As one can see from the range of figures calculated by the staff, the use of different LSFO prices can result in a figure as low as $27 million and as high as $114 million. However, we find that staff has selected the best available guidelines in determining from within this range what these disposal costs and purchase prices reasonably would have been.

We do find two flaws in the staff calculation. First, as pointed out by SDG&E, staff has used beginning-of-the-year present value factors rather than mid-year factors. We agree with SDG&E that use of the mid-year factors is appropriate. Second, we note that staff has limited its calculated penalties for gas rejection in the months of July 1980 and January 1981, to the LSFO volumes under the 1974 contract with Tesoro, as amended. The only reason offered by staff for this limitation is that staff did not want to penalize SDG&E for taking any HIRI LSFO. However, there is no valid reason why staff's method should be limited to the underlying 1974 contract volumes. The purpose of staff's method is to maximize the gas burn and to dispose of excess LSFO, regardless of its supplier. The staff's method does not imply that the level of the Tesoro 1974 contract volumes or the HIRI LSFO volumes were unreasonable but only that SDG&E should have disposed of this LSFO if it could be replaced with gas. If one corrects these two flaws, staff's calculation is reduced to $63,647,000.

3. City

The City's alternative calculation of $74 million is based on a hybrid approach. City has used SDG&E's exhibits and data responses to calculate what the benefits of the Agreement were from 1979 to mid-1981. City then draws upon the staff exhibit to determine what the detriments of the Agreement were from

mid-1981 to 1983.

The City's approach is subject to the same criticisms we have made of SDG&E and staff calculation methods.

The City's determination of benefits from the Agreement is overstated to the extent it does not recognize the actual gas burn or take into account LSFO storage availability. The City has assumed like SDG&E that the Agreement's lower LSFO volumes from 1979 to mid-1981 enabled SDG&E to burn more gas. This has not been demonstrated on this record.

The City's determination of detriments from the Agreement does recognize SDG&E's actual operating conditions since it is taken from the staff calculation. However, the City also has used improper present value factors and limitations on gas rejections.

City has not explained why this hybrid approach is appropriate other than to say that in its view this is one way to measure the economic difference between the Agreement and the underlying 1974 contract with Tesoro, as amended.

4. The ALJ's Recommended Disallowance

The record now contains three disallowance figures which may be adopted by the Commission: $97 million, $72 million, and $63 million.

The $97 million figure increases slightly to $98 million if present value factors are used. Again, this figure is based on replacement fuel costs for the different LSFO volume requirements imposed by the Agreement. It is not based upon actual LSFO deliveries or the recorded availability of natural gas but refers only to the actual contract changes with Tesoro.

The second $72 million figure is drawn from SDG&E's proposal to disallow the risk or burden assumed by SDG&E in its analysis of

the proposed Agreement. Under this method, SDG&E is penalized for the risk that it reasonably should have foreseen when it signed the Agreement.

The third $63 million figure is derived under the staff method from recorded data. This method assumes that absent the Agreement SDG&E could have managed its fuel mix to take advantage of all available natural gas. This method does incorporate SDG&E's recorded LSFO burn and the recorded availability of natural gas.

In addition to these three figures, the Commission may develop its own disallowance figure drawn from the considerable evidence received in the record for this proceeding. For example, we can see from SDG&E's data responses that in 1979 SDG&E had adequate storage capacity to accept the unreduced Tesoro LSFO volumes and still burn all available natural gas. Thus, the Commission may conclude that the Agreement actually resulted in no benefits in 1979 other than a lower LSFO inventory level. And of course since SDG&E's shareholders bore excess inventory carrying costs in 1979, the ratepayers would not have received any benefit of a reduced LSFO inventory in that year. As another example, the Commission could calculate what the benefits of the Agreement were by examining actual Tesoro deliveries from 1979 to mid-1981 rather than the final contract levels. Most of these refinements would raise a disallowance figure calculated by the parties.

The ALJ proposed that the Commission adopt a disallowance of $70 million to be refunded to SDG&E's ratepayers in its ECAC balancing account. In the ALJ's view, this recommended disallowance is towards the low end of the three disallowance figures that could be adopted. According to the ALJ, since some of these figures could be increased, it is a minimal figure, when viewed in the light of Czahar's financial analysis which indicates that a $70 million disallowance will not have a lasting financial impact on SDG&E, and that a disallowance as high as $120 million will not harm SDG&E.

5. The Adopted Disallowance

In our Interim Opinion, D.84-02-005, we directed the parties to submit calculations on the actual consequences of the Agreement. Although we found that the Agreement was unreasonable, at that time we did not know what the effects of the Agreement were apart from the $45 million in underlift payments made under the 1982 Tesoro Suspension Agreement. At that point we could have simply disallowed the $45 million in underlift payments. However, since SDG&E claimed it had entered into the Agreement to enable a greater gas burn in 1979 and 1980, we extended the proceeding to determine what fuel savings had occurred due to the lower contract volumes in those years. It was our expectation that consideration of the fuel savings would offset some of the underlift payments. This was not the case.

After reviewing SDG&E's records, we now know that the Agreement's lower volumes for 1979 did not enable a greater gas burn or any fuel savings. SDG&E could have accepted the original Tesoro volumes and still burned all available gas in 1979. Any excess LSFO could have been stored in SDG&E's inventory. (SDG&E's average LSFO inventory level in 1979 was 1.873 million barrels while its tank capacity was 3.8 million barrels.) By entering into the Agreement, SDG&E was able to reduce its LSFO inventory carrying cost in 1979. The Agreement's lower volume in that year did not affect the gas burn. However, in 1980 and the first half of 1981, SDG&E did realize some fuel savings due to the Agreement's lower volumes. Most of the savings occurred in the first half of 1981 because the oil/gas price differential unexpectedly had increased to $24-$30 per barrel.

After mid-1981, the Agreement's extended term raised SDG&E's fuel costs. The Agreement's higher volumes in the mid-1981 to 1983 period forced SDG&E to reject cheaper natural gas, to sell excess LSFO at a loss, and to pay underlift penalties to Tesoro. In addition, the Agreement increased SDG&E's inventory carrying costs over this period. From mid-1981, the Agreement

increased SDG&E's fuel expenses.

There are several ways of quantifying the above consequences of the Agreement. The ALJ proposed a disallowance of $70 million. This recommendation is drawn from a range of $63 million to $97 million which he finds is established in the record. We agree that the Agreement has increased SDG&E's fuel costs over the 1979-1983 period by at least $60 million,[1] and perhaps as high as $97 million. We are simply not comfortable with this range of figures.

We will confine our consideration of the disallowance to expenses caused by the agreement with Tesoro in the period July 1, 1982 to December 31, 1983. Although this record period concludes April 30, 1983, we have necessarily reviewed all of the costs related to SDG&E's Tesoro agreements in this proceeding. We choose not to adjust the balancing account for the period January 1, 1979 to June 30, 1982.

We are reluctant to make adjustments to the expenses incurred in record periods for which we already have issued decisions. We already have reviewed the January 1, 1980 to June 30, 1982 period and issued decisions on the reasonableness of expenses incurred over that time period. (See D.82-04-115 issued April 28, 1982 and D.82-12-056 issued December 13, 1982). While we have only partially reviewed the 1979 record period and have retained jurisdiction to disallow fuel related expenses for that prior period,[2] the Agreement itself did not affect fuel expenses in that year, and the exclusion of this period does not change the disallowance.

We also note that inclusion of this period would raise the calculated disallowance since the Agreement did not bring about any

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[1] Even SDG&E's calculation of $33 million increases to $60.5 million when the 1979 fuel savings is removed.

[2] See the "express reservation" provisions of D.91106 issued December 19, 1979 and D.91545 issued April 15, 1980.

fuel savings in 1979. The realized fuel savings in 1980 and the first half of 1981 are substantially outweighed by the later expense from rejecting natural gas, the losses on excess LSFO sales, and the underlift payments to Tesoro in the July 1, 1981 to June 30, 1982 period. Consideration of the January 1, 1979 to June 30, 1982 period increases rather than decreases the disallowance which could be imposed on SDG&E.

We recall the Commission's statement in D.92496 issued December 5, 1980 that adjustments to prior record periods "could be damaging to the financial standing of California utilities because of the corresponding assumption that reported earnings would be subject to possible adjustment for years in the future." (4 CPUC 2d 701.) By confining our consideration of the disallowance to the July 1, 1982 - December 31, 1983 period, we will avoid adjustment of prior reported earnings for SDG&E.

In reviewing the full range of figures developed in this record, we conclude that the only solid figure is the underlift penalty associated with the Suspension Agreement. In making a disallowance, we will not attempt a calculation for the record period months of July, August and September 1982, because we are not comfortable calculating a figure for the oil/gas differential for these months. However we know that from October 1, 1982 to December 31, 1983, SDG&E did not receive any LSFO from Tesoro and instead paid a $6.55/bbl underlift penalty, or a total of $45,060,000 in underlift penalties. This is the amount we will disallow.

We emphasize that we will continue to review discretionary utility actions and management decisions which affect expenses in a record period even though those actions and decisions may have been made at an earlier time. For example, the reasonableness of expenses paid pursuant to a particular long-term contract will be an issue not only initially as to whether the utility should have entered the contract at all, but further in each and every record period for which rate recovery is sought, and for which the

contract is in effect. Otherwise, a utility could be encouraged to enter into contracts which may yield immediate benefits but over the contract term are imprudent. Recently, we addressed this very issue in reviewing the increased coal costs resulting from the renegotiation of Edison's contract with Utah International Corp., in Edison's 1982 reasonableness review proceeding. In our decision we concluded that "The price paid under the renegotiated Utah International coal supply contract was reasonable during the review period; Edison for future reasonableness periods should bear the burden of proving the reasonableness of the price paid under the renegotiated terms." (D.84-09-120, mimeo. p. 98.)

To reiterate, our primary focus is the review of the reasonableness of expenses incurred by a utility during the record period, *given the existence of the contract*. To accomplish this task, it may be necessary to continuously reassess the reasonableness of the contract itself. This does not mean that long-term contracts are to be discouraged in favor of "flexible" short-term contracts or that the intrinsic benefits often embodied in long-term contracts will be disregarded for ratemaking purposes. We merely state the obvious: neither utility management nor utility regulators operate in a static environment. Both must act responsibly and responsively as circumstances change. As a previous Commission so aptly stated:

> "[The utility's] theory that once it is determined that it entered into a reasonable and prudent contract, its shareholders are absolved from all risks, is not correct in that it neglects the very important factor of changed cirumstances [*sic*].
>
> "Whether or not a contract should remain in effect, be abrogated, or be renegotiated should be decided by utility management. It seems obvious that normally utility management will consider a change in the status quo only when there is an incentive for it to do so. If we pass through all expenses without determining their reasonableness simply because they have been contracted for, there would never

> be an incentive for utility review of such expenses. Our review of the reasonableness of contract expenses with the possibility of disallowance provides management incentive to incur only reasonable costs." (D.82-12-109 10 CPUC 2d 488, 492-493.)

We fully expect this disallowance will be the last of its type for SDG&E. SDG&E does have new procedures and new personnel in its fuel procurement department. We are confident that with these changes, current management has taken the steps necessary to avoid the kind of mistakes of the past that led to the Agreement causing this disallowance.

C. ALJ Rulings

SDG&E asks the Commission to overturn the ALJ's evidentiary rulings excluding some of SDG&E's prepared testimony and admitting staff testimony.

A review of the excluded testimony shows that it was prepared to reargue the reasonableness of the Agreement. SDG&E has read the Interim Opinion, D.84-02-005 to say only that SDG&E's procedures and motivations were unreasonable, not the Agreement. SDG&E's hired consultants then were instructed to determine whether absent these unreasonable procedures and motivations, SDG&E reasonably could have entered into the Agreement. Not surprisingly, each of the consultants has concluded that the Agreement was "reasonable."

D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it entered into the Agreement. After the Commission found that the Agreement itself was unreasonable, the Commission went on in D.84-02-005 to discuss some of the reasons why SDG&E entered into such an unreasonable Agreement. The Commission stated that SDG&E had not conducted adequate studies, SDG&E had not properly evaluated the uncertainty of its gas forecasts, and SDG&E had

attempted to shield its shareholders from certain penalties at the expense of the ratepayers. The primary finding that the Agreement was unreasonable is not dependent on the latter discussion which identifies additional conduct by SDG&E that was unreasonable.

In short, SDG&E does not accept the plain meaning of D.84-02-005 and has sought in its excluded testimony to relitigate the reasonableness of the Agreement. The ALJ has properly excluded this evidence.

We observe that D.84-02-005 was issued after the receipt of testimony from the SDG&E officer who actually signed the Agreement in 1979. Such testimony is the best evidence that could be offered of the circumstances surrounding the Agreement. The testimony of hired consultants who did not participate in the negotiation or the signing of the Agreement would pale in comparison to the testimony of such a percipient witness.

SDG&E also argues that since the Interim Opinion did not describe an alternative course of action, the Commission has not yet determined that the Agreement was unreasonable, just SDG&E's procedures and motivations. There are *many* reasonable courses of action that SDG&E could have followed in 1979. The Agreement was not one of them. If this truly is not apparent to SDG&E , [*sic*] we must conclude that despite its loud claims of improvement, SDG&E's fuel management department has not progressed since 1979.

A reasonable and prudent utility manager would not have signed the Agreement that SDG&E did. As stated in D.84-02-055, SDG&E extended its Tesoro obligation beyond the expiration date to a period when it already had under contract adequate LSFO supplies from HIRI. SDG&E signed the Agreement when its probability analysis indicated that the different LSFO volumes created just offsetting risks of excess LSFO. SDG&E signed the Agreement when its own economic analysis predicted net fuel savings of

just $500,000. And SDG&E signed the Agreement, whose primary benefit supposedly was a reduction of contract volumes in 1979 and 1980 to enable an increased gas burn, when the most recent projection of LSFO requirements cited by its witness showed that LSFO requirements exceeded the total supplier volumes *without* any reduction in contract volumes.

A reasonable and prudent utility manager would have undertaken a course of action in which the perceived benefits outweighed the risks. SDG&E did just the opposite.

A reasonable and prudent utility manager would have recognized in 1979 that since its forecasts were highly uncertain, the company should certainly maintain and strive to increase its fuel mix flexibility to allow for unexpected conditions. As stated in D.84-02-005, SDG&E unwisely gave up the flexibility it had under the HIRI contract when it signed the Agreement. SDG&E to this day does not acknowledge that it had any flexibility under the HIRI contract. Of course, SDG&E realizes now that reliance on the flexibility of the HIRI contract was one obvious alternative to the Agreement which would have substantially lowered its fuel costs.

SDG&E's narrow interpretation of the HIRI contract provisions is not supported by the facts. As can be seen in the following table, from 1974 to 1978 SDG&E was able to negotiate large reductions of the original contract volumes without paying any underlift charges to HIRI.

Table 1

HIRI Contract Requirements - MBBL Per Year

	1975	**1976**	**1977**	**1978**	**1979**	**1980**
8/74 Contract	6,278	7,665	10,512	10,512	10,512	10,512
11/74 Amend. 1	5,427	7;665	10,512	10,512	10,512	10,512
2/76 Amend. 2		6,768	10,512	10,512	10,512	10,512
8/76 Amend. 4			6,935	10,512	10,512	10,512
11/77 Amend. 6				6,132	10,512	10,512
5/78 Amend. 7				5,366	5,110	5,110

By 1979, SDG&E on five occasions was able to negotiate substantial volume reductions when it became apparent that it did not need as much LSFO as the contract required SDG&E to take.

Amendment No. 7 was in effect when SDG&E signed the Agreement. SDG&E's witness Niggli testified that in his opinion Amendment No. 7 increased the flexibility in volumes SDG&E already had under the HIRI contract. This opinion is confirmed by the fact that SDG&E was able to subsequently negotiate another large reduction in the minimum contract volumes without paying any underlift charges to HIRI.

As suggested in D.84-02-005, a prudent and reasonable utility manager would have relied upon the flexibility in the HIRI contract. SDG&E literally threw this flexibility away. The company should have known that it would have been better off not signing the Agreement. We do not say now or in D.84-02-005 that the only path SDG&E reasonably could have followed in 1979 was adherence to the status quo. In D.84-02-005, we simply have found that the Agreement was an unreasonable alternative to the status quo. Based on the facts and circumstances existent in 1979, the Agreement was a step in the wrong direction. There are perhaps more reasonable courses of action the company could have followed rather than adhering to the status quo. However, SDG&E has not attempted to present these alternatives in its testimony and instead has tried only to reargue the reasonableness of the Agreement.[3]

On the other hand, staff has presented in its testimony an alternative to the Agreement which in staff's opinion was a reasonable course of action available to SDG&E in 1979. Staff has fully accepted the finding in D.84-02-005 that the Agreement was

[3] Although one SDG&E witness, William Hughes, does identify several alternatives to the Agreement, his prepared testimony is not a measurement of the likely consequences of these alternatives against the recorded costs under the Agreement. Rather, his testimony is limited to a determination that in late 1978 none of his selected alternatives seemed better than the Agreement.

unreasonable; SDG&E clearly has not. For this reason, staff's evidence was properly admitted while SDG&E's evidence was excluded.

SDG&E's motion to overturn the ALJ's evidentiary rulings shall be denied.

E. Disclosure of Documents

SDG&E admits that it has given less than six documents to Commissioners or their aides which were not served upon the parties. SDG&E was unwilling to reveal the contents of these documents and stated only that they were distributed before the Commission issued D.84-02-005.

SDG&E has not denied the relevance of these documents to this phase of the proceeding. Accordingly, we must assume that they are relevant to the determination of a disallowance in this phase of the proceeding.

Public Utilities Code (PUC) § 1705 requires this Commission to make findings of fact and conclusions of law based on evidence in the record. The parties are entitled to examine these documents so that they may assure themselves that the Commission has properly based its ultimate decision on the record. We will direct SDG&E to serve the documents on all parties.

Findings of Fact

1. A disallowance of $70 million will not severely alter SDG&E's financial position after 1984.

2. SDG&E's financial position is substantially improved since the construction of SONGS 2 and 3 is completed and the company is able to normalize its income taxes.

3. A disallowance of $70 million will not harm SDG&E's credit worthiness or threaten its ability to provide safe and reliable

service to its customers.

4. SDG&E's evidence and testimony on the financial impact of a disallowance was not supported by any analysis of SDG&E's current financial condition and lacked credibility.

5. A disallowance figure of $97 million may be calculated based on the LSFO volume differences negotiated in the Agreement and subsequent contract amendments.

6. A disallowance figure of $72 million may be calculated based on the risk that was reasonably foreseeable to SDG&E when it signed the Agreement.

7. A disallowance figure of $63 million may be calculated based on a maximum burn of natural gas that was available to SDG&E from 1979-1983.

8. Some of the disallowance figures could be increased if SDG&E's actual operating conditions from 1979 to mid-1983 are recognized.

9. SDG&E's adjustments to the $97 million figure were limited to the detriment period of mid-1981 to 1983; SDG&E did not make similar adjustments for the benefit period of 1979 to mid-1981.

10. The ALJ proposes a disallowance of $70 million based on the range of disallowance figures in the record and the staff's financial analysis.

11. SDG&E in the testimony of its hired consultants attempted to reargue the reasonableness of the Agreement.

12. SDG&E has misread D.84-02-005 to say only that the company's procedures and motivations were improper.

13. D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it signed the Agreement.

14. SDG&E has informally distributed documents to Commissioners or their aides which were not served on all parties to this proceeding.

15. The assigned Commissioner issued a ruling denying SDG&E's petition to disqualify the ALJ in this proceeding.

16. To eliminate any uncertainty over the outcome of this proceeding, this order should take effect on the date of issuance.

17. A disallowance of $45,060,000.00 is appropriate based on the underlift payments ($6.65/Bbl) made by SDG&E to Tesoro from October 1, 1982 to December 31, 1983.

18. Disallowance of expenses incurred in prior record periods should be avoided so that a utility's reported earnings for those periods are not affected.

Conclusions of Law

1. The disallowance adopted in this decision is just and reasonable.

2. The ALJ's evidentiary rulings were correct.

3. SDG&E should serve upon the parties the documents that it has informally given to Commissioners or their aides.

4. The assigned Commissioner's ruling declining to disqualify ALJ Wu should be affirmed.

FINAL ORDER

IT IS ORDERED that:

1. San Diego Gas & Electric Company (SDG&E) shall refund to its ratepayers $45,060,000.00 as of January 1, 1985 through its Energy Cost Adjustment Clause balancing account.

2. SDG&E's motion to overturn the Administrative Law Judge's evidentiary rulings is denied.

3. SDG&E shall, within 10 days of the date of issuance of this order, serve upon all parties all documents it has distributed to Commissioners or their aides.

4. The assigned Commissioner's ruling is affirmed.

This order is effective today.

Dated December 5, 1984, at San Francisco, California.

DONALD VIAL
President
VICTOR CALVO
PRISCILLA C. GREW
Commissioners

I dissent.

/s/ WILLIAM T. BAGLEY
Commissioner

I dissent.

/s/ FREDERICK R. DUDA
Commissioner

Decision 85 04 111 APR 17 1985

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN DIEGO GAS AND ELECTRIC COMPANY, for authority to revise its Energy Cost Adjustment Clause Rate, to revise its Annual Energy Rate, and to revise its Electric Base Rates in accordance with the Electrical Revenue Adjustment Mechanism established by Decision 93892.	Application 83-07-16 (Filed July 8, 1983)

ORDER MODIFYING DECISION 84-12-026 AND DENYING REHEARING OF DECISIONS 84-02-005 AND 84-12-026

Applications for rehearing of Decisions (D.) 84-02-005 and 84-12-026 have been filed by the San Diego Gas & Electric Company (SDG&E). Those decisions were issued on February 1 and December 5, 1984, respectively. At SDG&E's request, action on its timely filed application for rehearing of D.84-02-005 was deferred until such time as both of its applications could be reviewed. We have examined all allegations of legal error raised by both applications and are of the opinion that sufficient grounds for granting rehearing have not been shown. However, our further review of the entire record in this case has persuaded us that several areas of the disallowance decision, D.84-12-026, should be modified, as set forth below.

IT IS ORDERED that D.84-12-026 is modified as follows:

1. The last paragraph of the discussion on page 29, mimeo, which continues to page 30, is modified to read:

> "There are several ways of quantifying the above consequences of the Agreement. The ALJ proposed a disallowance of $70 million. This recommendation is drawn from a range of $63 million to $97 million which he finds is established in the record. We agree that the Agreement had increased SDG&E's fuel costs over the 1979-1983 period by at least $60 million, and perhaps as high as $97 million. However, as stated in D.84-02-005, we may determine an appropriate disallowance both from these calculations and all other relevant factors, and are not bound by the arithmetic results."

2. The first two full paragraphs on page 30, mimeo., are modified to read:

> "We will confine our consideration of the disallowance to expenses caused by the agreement with Tesoro in the period July 1, 1982 to December 31, 1983. Although this record period concludes April 30, 1983, we have necessarily reviewed all of the costs related to SDG&E's Tesoro agreements in this proceeding. While we could have reached back to the beginning of the Agreement, for reasons largely unique to this case we will not adjust the balancing account for the period January 1, 1979 to June 30, 1982.
>
> "We are reluctant to make adjustments to the expenses incurred in record periods for which we already have issued reasonableness decisions. [The remainder of the paragraph is the same.]"

3. The first paragraph on page 31, mimeo., is modified to read:

> "We recall the Commission's statement in D.92496 issued December 5, 1980 that adjustments to prior record periods "could be damaging to the financial standing of California utilities because of the corresponding assumption that reported earnings would be subject to possible adjustment for years in the future." (4 CPUC 2d 701). By confining our consideration of the disallowance to the July 1, 1982-December 31, 1983 period, we will avoid adjustment of prior reported earnings for SDG&E. We stress, however, that it is not only this consideration, but also the unique factors, discussed above, which this case presents, which have compelled our approach here."

4. The second paragraph on page 31, mimeo., is deleted and the following paragraph substituted:

> "From July 1, 1982 to December 31, 1983, SDG&E incurred the following expenses due to the Agreement. In the months of July, August, and September 1982, SDG&E rejected 952,500 barrels equivalent of natural gas. The oil/gas price differential at this time was about $15. However, we will use the $7.93/bbl average difference calculated by the ALJ for the period January-May 1979. We believe that any disallowance should be limited to the price differential that was reasonably foreseeable when SDG&E entered into the Agreement. Accordingly, an appropriate disallowance for these three months would be 952,000 barrels × $7.93/bbl = $7,553,325.00. From October 1, 1982 to December 31, 1983, SDG&E did not receive any LSFO from Tesoro but instead paid $6.55/bbl

underlift penalty or a total of $45,060,000.00 in underlift penalties. This amount should also be added to the disallowance for this period as a cost which was not reasonably incurred. The total disallowance for the entire period would be $52,613,325.00. We could assess this disallowance against SDG&E with impunity, as it is fully supported by the record. However, our sense of equity persuades us that this amount is somewhat too great a burden for SDG&E to bear. We will, therefore, adopt as the appropriate disallowance only the $45,060,000 in underlift penalties. This amount shall be refunded, to SDG&E's ratepayers through the balancing account effective January 1, 1984."

5. The first full paragraph on page 34, mimeo., is modified to read:

"SDG&E also argues that since the Interim Opinion did not describe an alternative course of action, the Commission has not yet determined that the Agreement was unreasonable, just SDG&E's procedures and motivations. There are *many* reasonable courses of action that SDG&E could have followed in 1979. The Agreement was not one of them."

6. The last paragraph on page 34, continuing on page 35, mimeo., is modified to read:

"A reasonable and prudent utility manager would have recognized in 1979 that since its forecasts were highly uncertain, the company should certainly maintain and strive to increase its fuel mix flexibility to allow for unexpected conditions. As stated in D.84-02-005, SDG&E unwisely gave up the flexibility it had under the HIRI contract when it signed

the Agreement. SDG&E to this day does not acknowledge that it had any flexibility under the HIRI contract."

7. Finding 17 is modified to read:

"A disallowance of $52.6 million is fully supported by the record and would be appropriate in this cse if (1) the disallowance is limited to expenses incurred in the July 1, 1982 to December 31, 1983 period and (2) the disallowance is further limited to the risk that SDG&E reasonably should have foreseen when it signed the Agreement."

8. New Finding 17A is added to read:

"A disallowance of $45,060,000, corresponding to the underlift penalties SDG&E had to pay after it ceased taking LSFO from Tesoro, comports with our sense of equity in this case."

9. Finding 18 is modified to read:

"Disallowance of expenses incurred in prior record periods, which would affect a utility's reported earnings for those periods, should be avoided in this case because reasonableness reviews have already occurred for some of those periods, inclusion of the 1979 period would not change the result because fuel costs were unaffected, and inclusion of the remaining periods would necessitate raising the amount of the disallowance."

10. Ordering Paragraph 1 is modified to read:

"San Diego Gas & Electric Company (SDG&E) shall refund to its ratepayers $45,060,000.00 million, as

of January 1, 1985 through its Energy Cost Adjustment Clause balancing account."

IT IS FURTHER ORDERED that rehearing of D.84-02-005 is denied.

IT IS FURTHER ORDERED that rehearing of D.84-12-026 as modified above is denied.

This order is effective today.

Dated April 17 1985, at San Francisco, California.

DONALD VIAL
President
VICTOR CALVO
WILLIAM T. EAGLEY
FREDERICK R. DUDA
Commissioners

I dissent.

PRISCILLA C. GREW, Commissioner

A.83-07-16
D.85-04-111

PRISCILLA C. GREW, Commissioner, Dissenting in part:

While I agree with the majority that the application for rehearing should be denied, I would order the company to refund to its ratepayers $52.6 million, with interest, as of January 1, 1984, through its Energy Cost Adjustment Clause balancing account.

I support the majority's disallowance of $45 million in underlift penalties. However, I would also add the additional expense incurred in July, August and September 1982 when SDG&E rejected 952,000 barrels equivalent of cheaper natural gas. While an even larger disallowance could be justified using the oil to gas price differential existing at that time, I would accept the ALJ's value of a differential of $7.93/bbl leading to a disallowance of $7,553,325. I would add this amount to the $45 million, giving $52.6 million.

In a recent filing objecting to SDG&E's application for rehearing, the City of San Diego included a request for interest on the disallowance. The Commission's usual practice in similar situations has been to include interest, and there is no obvious reason why it should not be included here.

/s/ Priscilla C. Grew
PRISCILLA C. GREW, Commissioner

April 26, 1985
San Francisco, California

A-74

ORDER DENYING WRIT OF REVIEW

S.F. No. 24889

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

IN BANK

SUPREME COURT
FILED
SEP 24 1985
Lawrence P. Gill, Clerk
DEPUTY

SAN DIEGO GAS AND ELECTRIC COMPANY, Petitioner

v.

PUBLIC UTILITIES COMMISSION ET AL., Respondents

Petition for writ of review DENIED.

Bird
Chief Justice

IN THE SUPREME COURT OF THE
STATE OF CALIFORNIA

San Diego Gas & Electric Company Appellant v. The Public Utilities Commission of the State of California, Appellee.	No. 24889 RECEIVED 85 DEC 2 SUPREME COURT SAN FRANCISCO

NOTICE OF APPEAL TO THE SUPREME COURT
OF THE UNITED STATES

Notice is hereby given that San Diego Gas & Electric Company, the appellant above-named, hereby appeals to the Supreme Court of the United States from the final judgement of the Supreme Court of the State of California, denying a writ of review of the decisions of the Public Utilities Commission of the State of California, entered in this action on September 24, 1985.

This appeal is taken pursuant to 28 U.S.C. § 1257(2).

Date: November 27, 1985

Jeffrey L. Guttero
Barton M. Myerson
101 Ash Street
San Diego, California 92101
(619) 235-7818

BY: Barton M. Myerson
Barton M. Myerson
Attorneys for Appellant
San Diego Gas & Electric Company

PROOF OF SERVICE BY MAIL

I, the undersigned state that I am a citizen of the United States and employed in the City and County of San Diego; that I am over the age of eighteen (18) years and not a party to the within cause; that my business address is 101 Ash Street, San Diego, California 92101; and that on the date set out below I deposited a true copy of the attached

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

sealed in envelopes with postage thereon fully prepaid in a mailbox regularly maintained by the Government of the United States in the said City and County and addressed as follows

City of San Diego
Leslie J. Girard
Deputy City Attorney
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Janice E. Kerr
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I certify under penalty of perjury under the laws of the State of California that the foregoing is true and correct:

November 27, 1985
(Date)

Adrienne Lapinan
(Signature)

LIST OF PROCEEDINGS INVOLVING PRUDENCE REVIEWS PENDING BEFORE THE CALIFORNIA PUBLIC UTILITIES COMMISSION

1. Application 82-02-40, *et al.*

   San Diego Gas & Electric Company (SDG&E) and Southern California Edison Company (Edison) have invested approximately *$4.5 billion* in San Onofre Nuclear Generating Station Units 2 and 3. The Commission expects to issue a decision in late 1986 after considering its Staffs' allegations that almost $1.2 billion of project costs were imprudently incurred.

2. Application 84-06-014.

   Pacific Gas and Electric Company (PGandE) has invested over $5.4 billion in its Diablo Canyon Nuclear Plant. The Commission will scrutinize the prudence of PGandE's investment during 1986.

3. Application 85-05-114.

   Edison owns 15.8 percent of the Palo Verde Nuclear Generating Station nuclear project. The Commission will review Edison's approximate $1.5 billion investment in this plant in 1986.

4. Application 85-05-055.

   Edison paid Chevron Oil Company approximately $350 million to settle a lawsuit concerning Edison's termination of a long-term fuel supply contract. The prudence of Edison's actions will be considered by the Commission during 1985-1986.

tion, the Supreme Court has recently upheld legislation prohibiting the dissemination of material depicting children engaged in sexual conduct. *New York v. Ferber*, 458 U.S. 747, 102 S.Ct. 3348, 73 L.Ed.2d 1113 (1982).

Having found that the Ordinance at issue here seeks to regulate speech (and not conduct), the next question before the Court is whether the Ordinance, which seeks to restrict the distribution, sale, and exhibition of "pornography" as a form of sex discrimination against women, falls within one of the established categories of speech subject to permissible government regulation, that is, speech deemed to be unprotected by the First Amendment.

It is clear that this case does not present issues relating to profanity, libel, or "fighting words."[1] In searching for an analytical "peg," the plaintiffs argue that the Ordinance most closely resembles obscenity, and is, therefore, subject to the requirements set forth in *Miller v. California*, 413 U.S. 15, 93 S.Ct. 2607, 37 L.Ed.2d 419 (1973). (Plaintiffs' Memorandum Of Law In Support Of Moving Plaintiffs' Motion Pursuant to Federal Rules of Civil Procedure 56 for Summary Judgment, pp. 18-23). But the defendants admit that the scope of the Ordinance is not limited to the regulation of legally obscene material as defined in *Miller*. (*See*, Answer of Defendants William H. Hudnut, III, et al., ¶ 9). In fact, defendants concede that the "pornography" they

[1] Defendants attempt to utilize the language "[words] by their very utterance inflict injury or tend to incite an immediate breach of the peace," *Chaplinsky*, 315 U.S. at 572, 62 S.Ct. at 769, as legal justification for upholding the Ordinance as unprotected speech. Their argument is that pornography "is nothing more than the infliction of injury on women," and is, therefore, unprotected under the First Amendment. (Defendants' Memorandum In Opposition To Plaintiffs' Motion For Summary Judgment, p.22.) In coming to this view, however, defendants have read this passage out of context. The quoted portion of *Chaplinsky* is in reference to the category of speech known as "fighting words," which by their very nature carry the immediate potential for injury. But "pornography" does not fall within the meaning of "fighting words," as that concept has come to be used. The rationale of *Chaplinsky* is, therefore, distinguishable from the instant case and thus not applicable here.

seek to control goes beyond obscenity, as defined by the Supreme Court and excepted from First Amendment protections. Accordingly, the parties agree that the materials encompassed in the restrictions set out in the Ordinance include to some extent what have traditionally been protected materials.

The test under *Miller* for determining whether material is legal obscenity is:

> "(a) whether 'the average person, applying contemporary community standards' would find that the work, taken as a whole, appeals to the purient [sic] interest, ...; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value." (citations omitted)

413 U.S. at 24, 93 S.Ct. at 2615.

It is obvious that this three-step test is not directly applicable [to] the present case, because, as has been noted, the Ordinance goes beyond legally obscene material in imposing its controls. The restrictions in the Indianapolis ordinance reach what has otherwise traditionally been regarded as protected speech under the *Miller* test. Beyond that, the Ordinance does not speak in terms of a "community standard" or attempt to restrict the dissemination of material that appeals to the "prurient interest." Nor has the Ordinance been drafted in a way to limit only distributions of "patently offensive" materials. Neither does it provide for the dissemination of works which, though "pornographic," may have "serious literary, artistic, political or scientific value." Finally, the Ordinance does not limit its reach to "hard core sexual conduct," though conceivably "hard core" materials may be included in its proscriptions.

Because the Ordinance spans so much more broadly in its regulatory scope than merely "hard core" obscenity by

limiting the distribution of "pornography," the proscriptions in the Ordinance intrude with defendants' explicit approval into areas of otherwise protected speech. Under ordinary constitutional analysis, that would be sufficient grounds to overturn the Ordinance, but defendants argue that this case is not governed by any direct precedent, that it raises a new issue for the Court and even though the Ordinance regulates protected speech, it does so in a constitutionally permissible fashion.

C. **Does established First Amendment law permit the regulation provided for in the Ordinance of otherwise protected speech?**

In conceding that the scope of this Ordinance extends beyond constitutional limits, it becomes clear that what defendants actually seek by enacting this legislation is a newly-defined class of constitutionally unprotected speech, labeled "pornography" and characterized as sexually discriminatory.

Defendants vigorously argue that *Miller* is not the "'constitutional divide' separating protected from unprotected expression in this area." (Defendants' Memorandum In Opposition To Plaintiffs' Motion For Summary Judgment, pp. 27-31). Defendants point to three cases which allegedly support their proposition that *Miller* is not the exclusive guideline for disposing of pornography/obscenity cases, and that the traditional obscenity test should not be applied in the present case. *See New York v. Ferber*, 458 U.S. 747, 102 S.Ct. 3348, 73 L.Ed.2d 1113 (1982); *FCC v. Pacifica Foundation*, 438 U.S. 726, 98 S.Ct. 3026, 57 L.Ed.2d 1073 (1978); *Young v. American Mini Theatres, Inc.*, 427 U.S. 50, 96 S.Ct. 2440, 49 L.Ed.2d 310 (1976).

Defendants first argue that the Court must use the same reasoning applied by the Supreme Court in *New York v. Ferber, supra*, which upheld a New York statute prohibit-

ing persons from promoting child pornography by distributing material which depicted such activity, and carve out another similar exception to protected speech under the First Amendment.

Defendants can properly claim some support for their position in *Ferber*. There the Supreme Court allowed the states "greater leeway" in their regulation of pornographic depictions of children in light of the State's compelling interest in protecting children who, without such protections, are extraordinarily vulnerable to exploitation and harm. The Court stated in upholding the New York statute:

> "The prevention of sexual exploitation and abuse of children constitutes a government objective of surpassing importance. The legislative findings accompanying passage of the New York laws reflect this concern: ...."

102 S.Ct. at 3355. The Supreme Court continued in *Ferber* by noting that the *Miller* standard for legal obscenity does not satisfy the unique concerns and issues posed by child pornography where children are involved; it is irrelevant, for instance, that the materials sought to be regulated contain serious literary, artistic, political or scientific value. In finding that some speech, such as that represented in depictions of child pornography, is outside First Amendment protections, the *Ferber* court stated:

> "When a definable class of material, such as that covered by §263.15, bears so heavily and pervasively on the welfare of children engaged in its production, we think the balance of competing interests is clearly struck and that it is permissible to consider these materials as without the protection of the First Amendment."

Id. at 3358.

Defendants, in the case at bar, argue that the interests of protecting women from sex-based discrimination are

analogous to and every bit as compelling and fundamental as those which the Supreme Court upheld in *Ferber* for the benefit of children. But *Ferber* appears clearly distinguishable from the instant case on both the facts and law.

As has already been shown, the rationale applied by the Supreme Court in *Ferber* appears intended to apply solely to child pornography cases. In *Ferber*, the court recognized "that a state's interest in 'safeguarding the physical and psychological well-being of a minor' is 'compelling.' *Globe Newspapers v. Superior Court*, ___ U.S. ___, ___, 102 S.Ct. 2613, 2621, 72 L.Ed.2d (1982)." 102 S.Ct. at 3354. *See also, FCC v. Pacifica Foundation, supra; Prince v. Massachusetts*, 321 U.S. 158, 168, 64 S.Ct. 438, 443, 88 L.Ed. 645 (1944); *Ginsberg v. New York*, 390 U.S. 629, 88 S.Ct. 1274, 20 L.Ed.2d 195 (1968). Also, the obscenity standard in *Miller* is appropriately abandoned in child pornography cases because it "[does] not reflect the State's particular and more compelling interest in prosecuting those who promote the sexual exploitations of children." *Id.* Since a state's compelling interest in preventing child pornography outweighs an individual's First Amendment rights, the Supreme Court held that "the states are entitled to greater leeway in the regulation of pornographic depictions of children." *Id.* at 3354.

On contrast, the case at bar presents issues more far reaching than those in *Ferber*. Here, the City-County Council found that the distribution, sale, and exhibition of words and pictures depicting the subordination of women is a form of sex discrimination and as such is appropriate for governmental regulation. The state has a well-recognized interest in preventing sex discrimination, and, defendants argue, it can regulate speech to accomplish that end.

But the First Amendment gives primacy to free speech and any other state interest (such as the interest of sex based equality under law) must be so compelling as to be

fundamental; only then can it be deemed to outweigh the interest of free speech. This Court finds no legal authority or public policy argument which justifies so broad an incursion into First Amendment freedoms as to allow that which defendants attempt to advance here. *Ferber* does not open the door to allow the regulation contained in the Ordinance for the reason that adult women as a group do not, as a matter of public policy or applicable law, stand in need of the same type of protection which has long been afforded children. This is true even of women who are subject to the sort of inhuman treatment defendants have described and documented to the Court in support of this Ordinance. The Supreme Court's finding in *Ferber* of the uncontroverted state interest in "safeguarding the physical and psychological well being of a minor" and its resultant characterization of that interest as "compelling," 102 S.Ct. 3348, 3354, is an interest which inheres to children and is not an interest which is readily transferrable to adult women as a class. Adult women generally have the capacity to protect themselves from participating in and being personally victimized by pornography, which makes the State's interest in safeguarding the physical and psychological well-being of women by prohibiting "the sexually explicit subordination of women, graphically depicted, whether in pictures or in words" not so compelling as to sacrifice the guarantees of the First Amendment. In any case, whether a state interest is so compelling as to be a fundamental interest sufficient to warrant an exception from constitutional protections, therefore, surely must turn on something other than mere legislative dictate, which issue is discussed more fully further on in this Opinion. *See* Section "C," *Infra.*

The second case relied upon by defendants to support their contention that *Miller* is not controlling in the present case is *FCC v. Pacifica Foundation*, 438 U.S. 726, 98 S.Ct. 3026, 57 L.Ed.2d 1073 (1978). According to defendants, *Pacifica* exemplifies the Supreme Court's refusal to make

obscenity the sole legal basis for regulating sexually explicit conduct.

In *Pacifica*, the Supreme Court was faced with the question of whether a broadcast of patently offensive words dealing with sex and excretion may be regulated on the basis of their content. 438 U.S. at 745, 98 S.Ct. at 3038. The Court held that this type of speech was not entitled to absolute constitutional protection in every context. *Id.* at 747, 98 S.Ct. at 3039. Since the context of the speech in *Pacifica* was broadcasting, it was determined only to be due "the most limited First Amendment protection." *Id.* at 748, 98 S.Ct. 3040. The reason for such treatment was twofold:

> "First, the broadcast media have established a uniquely pervasive presence in all the lives of all Americans. Patently offensive, indecent material presented over the airwaves confronts the citizen, not only in public, but also in the privacy of the home, where the individual's right to be left alone plainly outweighs the First Amendment rights of an intruder."
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> * * *
>
> Second, broadcasting is uniquely accessible to children, even those too young to read..."

Id. at 748-49, 98 S.Ct. at 3040.

Although the defendants correctly point out that the Supreme Court did not use the traditional obscenity test in *Pacifica*, this Court is not persuaded that the rule enunciated there is applicable to the facts of the present case. The Ordinance does not attempt to regulate the airwaves; in terms of its restrictions, it is not even remotely concerned with the broadcast media. The reasons for the rule in *Pacifica*, that speech in certain contexts should be afforded minimal First Amendment protection, are not present here, since we are not dealing with a medium that "invades" the privacy of the home. In contrast, if an individual is offended by "pornography," as defined in the

Ordinance, the logical thing to do is avoid it, an option frequently not available to the public with material disseminated through broadcasting.

In addition, the Ordinance is not written to protect children from the distribution of pornography, in contrast to the challenged FCC regulation in *Pacifica*. Therefore, the peculiar state interest in protecting the "well being of its youth," *id.* at 649, 98 S.Ct. at 3040 (quoting *Ginsberg v. New York*, 390 U.S. 629, 33 S.Ct. 1274, 20 L.Ed.2d 195 (1968)), does not underlie this Ordinance and cannot be called upon to justify a decision by this Court to uphold the Ordinance.

The third case cited by defendants in support of their proposition that the traditional obscenity standard in *Miller* should not be used to overrule the Ordinance is *Young v. American Mini Theatres, Inc.*, 427 U.S. 50, 96 S.Ct. 2440, 49 L.Ed.2d 310 (1976). In *Young* the Supreme Court upheld a city ordinance that restricted the location of movie theatres featuring erotic films. The Court, in a plurality opinion, stated that "[e]ven though the First Amendment protects communication in this area from total suppression, we hold that the State may legitimately use the content of these materials as the basis for placing them in a different classification from other motion pictures." 427 U.S. at 71-72, 96 S.Ct. at 2452. The Court concluded that the city's interest in preserving the character of its neighborhoods justified the ordinance which required that adult theaters be separated, rather than concentrated, in the same areas as it is permissible for other theaters to do without limitation. *Id.* at 71, 96 S.Ct. at 2452-53.

Young is distinguishable from the present case because we are not here dealing with an attempt by the City-County Council to restrict the time, place, and manner in which "pornography" may be distributed. Instead, the Ordinance prohibits completely the sale, distribution, or exhibition of material depicting women in a sexually subordinate role, at all times, in all places and in every manner.

The Ordinance's attempt to regulate speech beyond one of the well-defined exceptions to protected speech under the first Amendment is not supported by other Supreme Court precedents. The Court must, therefore, examine the underlying premise of the Ordinance: that the State has so compelling an interest in regulating the sort of sex discrimination imposed and perpetuated through "pronography" that it warrants an exception to free speech.

C. Is sex discrimination a compelling state interest justifying an exception to First Amendment Protections?

It is significant to note that the premise of the Ordinance is the sociological harm, *i.e.*, the discrimination, which results from "pornography" to degrade women as a class. The Ordinance does not presume or require specifically defined, identifiable victims for most of its proscriptions. The Ordinance seeks to protect adult women, as a group, from the diminution of their legal and sociological status as women, that is, from the discriminatory stigma which befalls women *as women* as a result of "pornography." On page one of the introduction to defendants' *Amicus* Brief, counsel explicitly argues that the harm which underlies this legislation is the "harm to the treatment and *status* of women ... on the basis of sex." *See* Brief of Linda Marchiano *Amicus Curiae*, page 1 (emphasis supplied).

This is a novel theory advanced by the defendants, an issue of first impression in the courts. If this Court were to accept defendants' argument — that the State's interest in protecting women from the humiliation and degradation which comes from being depicted in a sexually subordinate context is so compelling as to warrant the regulation of otherwise free speech to accomplish that end — one wonders what would prevent the City-County Council (or any other legislative body) from enacting protections for other equally compelling claims against exploitation and discrimination as are presented here. Legislative bodies,

finding support here, could also enact legislation prohibiting other unfair expression — the publication and distribution of racist material, for instance, on the grounds that it causes racial discrimination,[2] or legislation prohibiting ethnic or religious slurs on the grounds that they cause discrimination against particular ethnic or religious groups, or legislation barring literary depictions which are uncomplimentary or oppressive to handicapped persons on the grounds that they cause discrimination against that group of people, and so on. If this Court were to extend to this case the rationale in *Ferber* to uphold the Amendment, it would signal so great a potential encroachment upon First Amendment freedoms that the precious liberties reposed within those guarantees would not survive. The compelling state interest, which defendants claim gives constitutional life to their Ordinance, though important and valid as that interest may be in other contexts, is not so fundamental an interest as to warrant a broad intrusion into otherwise free expression.

Defendants contend that pornography is not deserving of constitutional protection because its harms victimize all women. It is argued that "pornography" not only negatively effects [sic] women who risk and suffer the direct abuse of

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[2] In *Beauharnais v. Illinois*, 343 U.S. 250, 72 S.Ct. 725, 96 L.Ed. 919 (1952), the Supreme Court upheld an Illinois libel statute prohibiting the dissemination of materials promoting racial or religious hatred and which tended to produce a breach of the peace and riots. It has been recognized that "the rationale of that decision turns quite plainly on the strong tendency of the prohibited utterances to cause violence and disorder." *Collins v. Smith*, 578 F.2d 1197, 1204 (7th Cir. 1978). The Supreme Court has recognized breach of the peace as the traditional justification for upholding a criminal libel statute. *Beauharnais*, 343 U.S. at 254, 72 S.Ct. at 729. Therefore, a law preventing the distribution of material that causes racial discrimination, an attitude, would be upheld under this analysis. Further, the underlying reasoning of the *Beauharnais* opinion, that the punishment of libel raises no constitutional problems, has been questioned in many recent cases. *See Collins, supra*, 578 F.2d at 1205, and cases cited therein.

its production,[3] but also, those on whom violent pornography is forced through such acts as compelled performances of "dangerous acts such as being hoisted upside down by ropes, bound by ropes and chains, hung from trees and scaffolds or having sex with animals. . . ." Defendants' Memorandum In Support To Plaintiffs' Motion For Summary Judgment, pp.3-4.[4] It is also alleged that exposure to pornography produces a negative impact on its viewers, causing in them an increased willingness to aggress toward women, *ibid.* at p.4, and experience self-generated rape fantasies, increases in sexual arousal and a rise in the self-reported possibility of raping. *Ibid.* at p.6. In addition, it causes discriminatory attitudes and behavior toward all women. *Ibid*, at pp.11-12. The City-County Council, after considering testimony and social research studies, enacted the Ordinance in order to "combat" pornography's "concrete and tangible harms to women." *Ibid.* at p.13.

Defendants rely on *Paris Adult Theatre I v. Slaton*, 413 U.S. 49, 98 S.Ct. 2628, 37 L.Ed.2d 446 (1965), to justify their regulation of "pornography." In that case the Supreme Court held "that there are legitimate state interests at stake in stemming the tide of commercialized obscenity ... [which] include the interest of the public in the quality of life and the total community environment, the tone of commerce in the great city centers, and, possibly, the public safety itself." 413 U.S. at 57-58, 93 S.Ct. 2635.

The Georgia Legislature had determined that in that case exposure to obscene material adversely affected men

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[3] The defendants point to social research data, as well as graphic personal accounts of individuals, in support of their position that "women are recruited into all forms of sexual exploitation through physical force, psychological coercion, drugs and economic exigencies." Defendants' Memorandum In Support To Plaintiffs' Motion For Summary Judgment, p.2.

[4] Examples of these types of "harms" were submitted to the City-Council at the public hearings held in regard to the Amendment. *See* Exhibits A-U.

and women, that is to say, society as a whole. Although the petitioners argued in that case that there was no scientific data to conclusively prove that proposition, the Court said, "[i]t is not for us to resolve empirical uncertainties underlying state legislation, save in the exceptional case where that legislation plainly impinges upon rights protected by the constitution itself." *Id.* at 60, 93 S.Ct. at 2636-37 (footnote omitted).

In *Slaton*, the Georgia Legislature sought to regulate "obscenity," an accepted area of unprotected speech. *See Miller v. Cohen* [sic], 413 U.S. 15, 93 S.Ct. 2607, 37 L.Ed.2d 419 (1973). The Court specifically found that "nothing precludes the State of Georgia from the regulation of the allegedly obscene material exhibited in Paris Adult Theatre I or II, provided that the applicable Georgia law, as written or authoritatively interpreted by the Georgia courts, meets the First Amendment standards set forth in *Miller v. California*..." 413 U.S. at 69, 93 S.Ct. at 2642 (citations omitted).

Based on this reasoning, defendants argue that there is more than enough "empirical" evidence in the case at bar to support the City-County Council's conclusion that "pornography" harms women in the same way obscenity harms people, and, therefore, this Court should not question the legislative finding. As has already been acknowledged, it is not the Court's function to question the City-County Council's legislative finding. The Court's solitary duty is to ensure that the Ordinance accomplishes its purpose without violating constitutional standards or impinging upon constitutionally protected rights. In applying those tests, the Court finds that the Ordinance cannot withstand constitutional scrutiny.

It has already been noted that the Ordinance does not purport to regulate legal obscenity, as defined in *Miller*. Thus, although the City-County Council determined that "pornography" harms women, this Court must and does

declare the Ordinance invalid without being bound by the legislative findings because "pornography," as defined and regulated in the Ordinance, is constitutionally protected speech under the First Amendment and such an exception to the First Amendment protections is constitutionally unwarranted.[5] This Court cannot legitimately embark on judicial policy-making, carving out a new exception to the First Amendment simply to uphold the Ordinance, even when there may be many good reasons to support legislative action. To permit every interest group, especially those who claim to be victimized by unfair expression, their own legislative exceptions to the First Amendment so long as they succeed in obtaining a majority of legislative votes in their favor demonstrates the potentially predatory nature of what defendants seek through this Ordinance and defend in this lawsuit.

It ought to be remembered by defendants and all others who would support such a legislative initiative that, in terms of altering sociological patterns, much as alternation may be necessary and desirable, free speech, rather than being the enemy, is a long-tested and worthy ally. To deny free speech in order to engineer social change in the name of accomplishing a greater good for one sector of our society erodes the freedoms of all and, as such, threatens tyranny and injustice for those subjected to the rule of such laws. The First Amendment protections presuppose the evil of such tyranny and prevent a finding by this Court upholding the Ordinance.

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[5] Defendants again rely on *Young v. American Mini Theatres, Inc.*, 427 U.S. 50, 96 S.Ct. 2440, 49 L.Ed.2d 310 (1976), contending that since the legislation in that case was upheld upon a single affidavit of a sociologist that the location of adult movie theatres had a disruptive impact on the community, the Ordinance should be upheld because there is more than enough data to demonstrate that pornography harms women. As discussed above in subpart B, however, the legislation in *Young* sought to regulate the place where pornography could be distributed, not to completely ban its distribution. Thus *Young* is not controlling.

III.

FIFTH AMENDMENT DUE PROCESS REQUIREMETS

Assuming *arguendo* that the Court had found that the State has a compelling interest in preventing sex discrimination which interest outweighs First Amendment rights, there remain other constitutional requirements which the Ordinance must satisfy in ordei to be upheld. The Court must determine if the Ordinance is unconstitutionally vague, if it is facially overbroad, if it constitutes a prior restraint on free speech, or if it violates procedural due process safeguards. The Court, therefore, shall here address each of these issues as if it had found the Ordinance to be properly-regulated speech.

A. Vagueness

Plaintiffs contend the Ordinance is unconstitutionally vague, in that it fails to give fair notice of the material intended to be regulated. Plaintiffs challenge a long list of words and phrases on the grounds they are unconstitutionally vague:

"pornography"
"graphic sexually explicit subordination"
"subordination of women"
"sexual objects for domination, conquest, violation, exploitation, possession or use"
"postures or positions of servility, submission, or display"
"special display presentations of pornography"
"a woman acting against the subordination of women"
"in the way women are injured by it"
"forcing pornography on a person"
"directly caused by specific pornography"
"the use of men, children or transsexuals in the place of women,"
"unlawful"
"isolated passages or isolated parts"